REPORT OF THE INQUIRY INTO THE COLLAPSE OF THE CCB AND NORTHLAND BANK

AUGUST
1986

By
THE HONOURABLE WILLARD Z. ESTEY
Commissioner

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TO HER EXCELLENCY
THE GOVERNOR GENERAL IN COUNCIL

MAY IT PLEASE YOUR EXCELLENCY

I, the Commissioner, appointed in accordance with the terms of Order in Council P.C. 1985-2932 of 29 September 1985, to inquire into and report on the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank, and to make any consequential recommendations for changes in the control of the banking industry in Canada:

BEG TO SUBMIT TO YOUR EXCELLENCY THE FOLLOWING REPORT.

Commissioner

27 August 1986

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Protocol

In order to assist the reader, the following list presents those abbreviations commonly found in the report.

BSDP	Bank Sponsored Drilling Program (CCB)
CBA	Canadian Bankers' Association
CCB	Canadian Commercial Bank
CDIC	Canada Deposit Insurance Corporation
CEO	Chief Executive Officer
CICA	Canadian Institute of Chartered Accountants
COC	Comptroller of the Currency (United States)
FDIC	Federal Deposit Insurance Corporation (United States)
FRB	Federal Reserve Board (United States)
GAAP	Generally Accepted Accounting Principles
LDT	Licensed Deposit-Taking Institution (United Kingdom)
MARGUN Loans	Marginal and Unsatisfactory Loans
MUL	Marginal and Unsatisfactory Loans
NAL	Nonaccrual Loan
NEL	Nonearning Loan
NPL	Nonperforming Loan

OIGB	Office of the Inspector General of Banks
OSC	Ontario Securities Commission
QSC	Quebec Securities Commission
REIT	Real Estate Investment Trust (CCB)
RRRL	Renegotiated Reduced Rate Loan
SBEC	Small Business Equity Corporation
SEC	Securities and Exchange Commission (United States)
SMART	Senior Management Assessment and Recovery Team (Northland Bank)
$M	Million Dollars
$B	Billion Dollars

Foreword

In the conduct of this Inquiry and the preparation of this report, I am indebted to the very small Inquiry staff assembled on short notice for this project. From the day following the issuance of the Order in Council proceedings took over almost completely, without prior notice, the time of the Commission counsel as well as the Commission's staff. It is very difficult to preempt without notice the time and availability of high calibre professional and administrative staff. Each one of them joined the Inquiry with personal inconvenience and sacrifice.

The analysis of a bank's operation relies heavily on accounting. Bank auditing is a specialty within the accounting profession and a bank auditor is a very rare bird. Because all the bank auditors in the country are somehow affiliated with accounting firms who hold appointments with one or more of the Schedule A banks, we were unable to locate an active bank auditor without some conflict of interest. We were very fortunate in enlisting the help of Vernon Turley, a retired bank auditor who was a partner of Coopers & Lybrand in Montreal and was engaged in the audit of major Canadian banks for almost 40 years. His insights into the complex and rarefied atmosphere of bank accounting and bank auditing procedures were of great assistance and were a unique contribution to this Inquiry. Because of his prior commitments, our demands upon him were sometimes met at great personal inconvenience.

The investigation and organization of the hearings fell entirely upon our Commission counsel, John Sopinka, Q.C. of Stikeman, Elliott, Toronto. A leading counsel in Canada and with particular experience in Commission of Inquiry work from both sides of that process, John Sopinka's contribution to the Inquiry was invaluable. He laid out the investigative program, examined almost all the witnesses and presented in a series of submissions over the life of the Inquiry both sides of all the issues seen to be relevant to the Commission's mandate. With an already full schedule of counsel work around the country, all this was accomplished at the expense of weekends and holidays.

In all this Mr. Sopinka was assisted by a brilliant young lawyer from Stikeman Elliott, Mr. Peter Howard. On him fell the burden of taking possession of the extensive documentation of the federal agencies and departments, of the two banks and of related organizations; and of analyzing, organizing and presenting the relevant portions of this material as exhibits for the Inquiry. In all he culled out and processed some thousands of pages of documents. While other counsel participating may sometimes have thought they should have received their bound books of exhibits with more lead time, no one challenged the fairness and efficiency with which Mr. Howard approached this monumental task. He also supervised the expurgation of this vast record of documents in order to protect the private information of persons who dealt with these banks in the ordinary course of business. Mr. Howard examined witnesses during the hearings and prepared submissions from various points of view on the issues raised in the evidence. All these studies were made available to all counsel before presentation at public hearing to the Commission. This great volume of work taxed to the limit even a young counsel of the vigour and training of Mr. Howard.

Serving as full-time Commission legal staff were two outstanding students of law, Jamie Benidickson and James T. Eamon. By the end of our project, each had been admitted to the bar (Ontario and Alberta respectively) and now look forward to what will certainly be distinguished careers in the law. Mr. Benidickson came to us already experienced in the work of a Commission of Inquiry. Mr. Eamon is my law clerk at the Supreme Court of Canada, as is Ms. Katherine Young, a law graduate from the University of Saskatchewan now completing articles for admission to the bar of Ontario. She divided her time between the Commission and the Supreme Court until preparation of the report commenced. In this process she conducted research into the various legal issues which the Commission confronted. These three persons were the core of our staff and the final form of the report was much influenced by their work. The time required to prepare this report was greatly abridged by the profound knowledge developed by Messrs. Eamon and Benidickson of the thousands of pages of transcripts and exhibits we collected. For the work and industry of these three highly skilled young law graduates I am most grateful.

Early in the Commission work assistance was obtained from Nigel Campbell of the Ottawa bar (now Toronto bar) in the regulatory framework of the United States and the United Kingdom and in the studies and developments underway in those countries. Professor David Cohen of the Faculty of Law of the University of British Columbia joined the Commission staff after the hearings were completed and contributed much to the organizing of the responses by the Commission to the many proposals received for the revision of legislation and administration and for the improvements to the principles of accounting that they apply to banking. We are all most appreciative of the work of Mr. Campbell and Professor Cohen.

May I also extend the thanks of the Inquiry to those people in the OIGB, the Bank of Canada and the Department of Finance, as well as to the liquidators of the two banks and the auditors of these banks for their assistance throughout the Inquiry. These were the principal sources of records and documents which the Commission required to do its work. Our invasions of these organizations were always cheerfully accepted in a spirit of cooperation. All this was very disruptive to these people and the Commission counsel and staff and myself are truly grateful for their help.

I particularly want to mention the work of the many counsel from Western Canada and Eastern Canada who represented agencies and individuals, some of the major banks, associations and government throughout these long and vigorous hearings. Many days, in order to accommodate travel schedules, the hearings went through 8 to 10 hours without interruption. In all these arduous times, matters proceeded in professional calm under the skilful management of these counsel, all of whom are listed at the end of this report. As is mentioned in the report, some of their clients may have had concerns with proceedings in other forums but with the forbearance expected of highly experienced and skilled professionals, these counsel at no time attempted to bend to their own interests the forum presented by this Inquiry. We were all saddened when Mr. Pierre Genest, Q.C., of Cassels, Brock, Toronto, who represented some of the CCB directors, was taken away by illness. We all missed his direct, incisive and witty interventions in our opening weeks.

We were fortunate, in organizing the work of the Inquiry, to obtain the help of Mr. Paul Ollivier, Q.C., who was lured out of retirement from the Public Service of Canada to act as Secretary of the Commission. By their very nature, Commissions of Inquiry cut across the rules, the methods and habits of the Public Service. Mr. Ollivier's broad knowledge of the experience in the Public Service were particularly useful in facilitating the work of the Commission and for this we are most grateful. Mr. Ollivier was ably assisted in his work by Donna Stebbing, Assistant Secretary, who came to us with experience in both the Public Service and Commissions of Inquiry. Her assistance, particularly in arranging our three lengthy sessions in Edmonton and Calgary, made the quick changes of locale possible. The task of moving thousands of pages of documents around the country and arranging for hearing facilities, shorthand reporters, word processor operators and translation personnel was not an easy one. For her help in this regard and in providing the paraphernalia of a main office in Ottawa, we are most grateful.

A word must be said about the press. As the report states, the Commission was throughout engaged in the delicate task of examining two banks without doing any unnecessary damage to the surrounding banking institutions. This required a constant balancing of the need for information in public examinations and the need of the banking institutions for protection from runs on deposits and loss of public confidence generally. The journalists, print and broadcast, reported these hearings with accuracy and fairness and did so unobtrusively. Television coverage was operated cooperatively by the TV news media and contributed to accurate and fair reporting without any apparent interference with the hearing process itself. This plan was proposed by the Ottawa Parliamentary Press Gallery and with some trepidation adopted by the Commission. It would appear to have been a very successful experiment.

The preparation in a relatively short period of time after completion of hearings of a report of several hundred pages means someone has put a great volume of words into a word processor, followed by corrections and redrafts. This was largely done by my secretary at the Supreme Court, Marjorie Harvey, who additionally organized the preparation of the report in a condition which facilitated its production in print form without further processing. The rest of us watched all this with great appreciation and amazement. Her stamina is exceeded only by her skill.

Telecom Canada arranged the satellite communication facilities by means of which the testimony of a British banker, a bank auditor and a banking expert from the United Kingdom was introduced into the Commission record by two-way television conducted in public in the course of the Ottawa hearings of the Commission. This was a considerable financial saving both to the Commission and to the United Kingdom participants. It also saved the Commission time in being able to hear this evidence in Ottawa when the United States bank regulatory practices were under examination. All this, Telecom Canada did without any charge to the public. It was a most successful experiment and the Commission appreciates the cooperation extended by Telecom Canada and its staff.

My absence from hearings in the Supreme Court in the winter and spring terms placed an added work load on the Chief Justice and my colleagues on the Court. Some of the work of the Court I was able to participate in during the course of the Inquiry but only with the assistance and patience of my judicial colleagues. For this I thank them as well as for their cooperation, forbearance and kindness in this difficult period.

Chapter 1

Summary

This Inquiry was directed to investigate the failures of the CCB and Northland Bank, to report upon the causes of these failures and the regulatory response to them and to recommend any changes in the regulation of the banking industry that these experiences may have shown to be necessary and advisable. This study involves the collapse of two banks which represented about one per cent of the Canadian banking system measured by assets, earnings or any other reasonable standard. It is therefore difficult in some instances to respond properly to proposals general in nature and affecting banking as a whole where the events in these two banks have not produced evidence relating to the proposals.

There is nothing in the considerable record of information assembled by the Inquiry to lead Canadians to fear any lack of strength and integrity in the Canadian banking system. The major banks, representing about 96 per cent of the assets of the industry, continue as world-scale banks whose strength and leadership is today recognized on the international stage of banking. Similarly, nothing has been revealed in the extensive record which indicates any basic inadequacy in the tripartite regulatory system which has been the mainstay of the regulation of banks in this country. No personal dishonesty in any person in private or public service has been revealed.

The complexity of the many issues which have arisen in these affairs and the huge flow of evidence, testimonial and documentary, defy reduction to a comprehensive, fair and accurate summary. An understanding of these events, their consequences in and to the Canadian community, and the solutions recommended requires reference to the whole report. What follows is a brief look at the highlights of the events, the problems encountered in the banks and by the regulators; and at the reactions of management, auditors, regulators, the government, and others to the principal adjustments and solutions recommended to improve the banking system and to reduce the chances of recurrence of these events with all their attendant losses to the community, private and public.

These were two small banks with headquarters in Western Canada. Northland charted its course as a regional bank. CCB intended to cast its net more broadly. Both founding groups saw their market niche as lenders to the mid-market commercial borrowers where the risks and the returns would be somewhat higher than in general banking operations. Funding for these loan operations was to come (and did for some time) from the wholesale money market. This, it was appreciated, would be more expensive than raising lending funds from retail depositors, but the added cost would be offset by the avoidance thereby of the need to establish a costly branch network, and by the anticipated higher returns from the type of lending. Northland also hoped to attract deposits from the credit union system, but this never developed into a significant funding source. The government of the day and its agencies, together with western provincial governments, saw a need for more competition generally in the banking business, and more particularly a need for western-based banks which would be more attentive to local interests.

The evidence reveals that probably there was no neglected niche in this market by the time these banks commenced business. The evidence is more readily open to the interpretation that the improvident lending practices of these banks created a demand from those lacking in the capacity to repay their borrowings and to whom credit should not have been extended. The rapid growth in both banks, spurred by the lending bonanza in the Western Canadian boom, increased the risk of making unsatisfactory loans. The plan of reliance on the wholesale money market for deposits was found by both banks to be entirely unsatisfactory and hazardous for small banks confined in their lending either sectorally, regionally or both. This realization unhappily came too late in the day. The same can be said of management's proclivity to take the easy path by lending large amounts of money to relatively few borrowers and making a significant number of loans to borrowers in the cyclical real estate and energy markets. Each bank also became excessively concentrated in limited geographic areas. These were some of the ills common to both banks, although each suffered from these ills in varying degrees.

If the two banks suffered from design flaws, so did the system in which they operated. The keeper of the gate of entry into the banking business is the Government of Canada. The plan advanced by the founders of each bank was laid out in detail in Parliamentary Committees. The Inspector General of the day testified that he saw no reason why the banks should not be incorporated. Four or five years later, the new *Bank Act* authorized the establishment of Schedule B banks and some 60 of them came into being in 1980-82. No provision was made in the Act for an enlargement of the inspection system or for any adjustment or realignment of that system to accommodate these new banks. The government of the day somehow overlooked the evident need to make some adjustments to the Act to accommodate the changing circumstances in banking and to study the inspection and regulation of banks in the light of these significant changes. In short, the adoption of a policy of expansion of the population of banks was not accompanied by a study of the complementary changes required in the supervisory system.

The role of the Minister of Finance and the Minister of State (Finance) is the execution of the regulatory policies in banking and the making of the final decision on a policy basis relating to the entry and exit of banks from the system. A Minister's reliance on the advice and information supplied by the regulatory staff is as inevitable as it is sensible. A Minister is not absolved from maintaining a policy surveillance over the operations of the supervisor, and must as well be responsible for the presence in the system of senior personnel of appropriate training and experience. The supervisory system and the principal persons in it were all in place well before the present Ministers assumed their responsibilities.

Northland Bank

Northland had many problems other than design flaws peculiar to itself. The bank suffered during much of its existence from a shortage of senior management experienced in banking. Through one-half of its entire history, the Chief Executive Officer of the bank was a person who had no banking experience. There was a large turnover in senior personnel. In its ten years of existence, the bank had four chief executive officers. The same velocity of roll-over occurred in many other senior management positions. Early lending practices were unconventional. The newly arrived Chief Executive Officer in 1981 described the bank as "run like a Mom and Pop shop". When trouble surfaced for all to see in 1982 a director resigned and a critical financial report authored by a financial advisor was circulated to the Board of Directors. Another director, who was not nominated for re-election, also expressed criticism of the bank to the Board, but no action was taken to change the direction of the bank.

Mr. Neapole, an experienced banker, joined the bank in 1983. He and his management team immediately recognized the serious condition of this bank. Accordingly, "survival tactics" were adopted for the purpose of gaining time in which to repair the troubles in the loan portfolio, the principal and virtually sole asset of a bank. The various strategies adopted by management had one object in common: to keep up an appearance of healthy financial condition in the bank's statements until better times returned to Alberta where the largest part of its business took place or until some of the restructured loan arrangements, called workouts, produced some income or recovery of principal.

The cornerstone of these strategies was a valuation standard for the loan assets which took into account future accretions to value by reason of the projected success of the workouts and anticipated improved economic conditions generally. The operational device applied very extensively by the Neapole team was the placing of nonperforming and otherwise unsatisfactory loans into a workout. That operational decision, according to the theory of the bank, immediately enhanced the value of the loan or the underlying loan security. That future value would be achieved at some indefinite time under undefined but improved economic conditions. This future value concept used in Northland justified, in management's opinion, the various accounting procedures in the bank including capitalizing interest and taking accrued interest (which by definition has not been received in cash) into the bank's statement of income although the borrower's ability to pay the interest was at least questionable. In addition, the inflated value of the loan or collateral security enabled management to defer or avoid setting up specific provisions against losses.

The loss experience on loans for the year consists of the net change in specific provisions plus write-offs less recoveries. This "loan loss experience" is charged to the appropriations for contingencies account carried in the capital and reserve section of the balance sheet. The "provision for loan losses" is based on the five-year historical loan loss experience expressed as a percentage of the loans outstanding and applied to the year end balance of loans, and is credited to the appropriation for contingencies account and charged to the statement of income. Consequently, the failure of a bank to set up a specific provision where prudent banking practice would have dictated that this be done results in an overstatement of the value of the loan assets in the balance sheet of the bank and an overstatement of income in the statement of income. Similarly, the capitalizing and accruing of interest, although uncollected, added value to the assets of the bank on its balance sheet and increased the stated income of the bank.

The triggers to all this are the decision to place the loan in a workout, the decision that principal and interest are ultimately collectable, and the valuation of loans on the basis of future values at some indefinite time under undefined improved economic conditions.

While all this activity was proceeding, the bank also undertook to increase its outstanding loans. This was intended to dilute the ever-rising number of nonperforming loans in the loan portfolio as a percentage of total outstanding loans. The plan was based on the assumption that all or most of the new loans would prove to be productive and would produce earnings for the bank. Unfortunately, this rapid expansion of lending occurred from 1982 onwards in the course of a long and severe recession in Alberta, which witnesses from both banks testified was the real cause of their respective failures. This produced new loans and increased balances on old loans and neither category was free from a substantial proportion of unsatisfactory loans.

Another strategy adopted by the Neapole management team was the development of "merchant banking". The merchant banking business enabled the bank to earn fee income. Fee income increased from 1983 levels by some 400 per cent in 1984. Characterizing a fee as the product of a merchant banking effort, rather than as the product of lending, enabled the bank to recognize the entire fee as income immediately and thereby avoid the amortization of the fee over the life of the loan had the fee been classed as being in lieu of interest. Three defects were ultimately revealed in relation to the bank's quest for fee income. First, the lending policy in many instances appeared to be fee driven, resulting in the booking of loans of doubtful quality in order to earn a fee. Second, the policy by its nature would force the bank to maintain its rapid rate of growth in order to maintain the same level of fees. Third, many of the so-called merchant-banking fees were revealed to be simply fees in connection with lending. These should have been amortized.

All these "survival tactics" were undertaken by a senior management evidently aware of the true condition of the bank generally, and of its loan portfolio in particular. It is the evidence as received by this Commission that this awareness was not fully shared by either the OIGB or the external auditors, and this is difficult to understand.

It is clear that management did succeed in maintaining an appearance of financial health by its tactics. The financial statements became gold fillings covering cavities in the assets and in the earnings of the bank. By conventional standards of banking and bank accounting the bank would have been shown as short on assets and earnings. The confidence of the money market would have been lost and deposits withdrawn. The bank, without outside assistance, would have had to close its doors as early as 1983.

Many adversities beset the bank. The CCB collapse in March 1985 shook the money markets. Northland was seen by the professional money managers as being in the same category as CCB. Deposits declined rapidly. The bank had begun to shift its funding base from wholesale to retail deposits but it was a slow and expensive process. Its interest spread narrowed. Without liquidity advances from the Bank of Canada to replace withdrawn deposits, the bank could not have carried on. Eventually these advances totalled about $500M.

The downhill slide makes much that followed anticlimactic. The ceaseless efforts of an enterprising management were directed to raising capital. This they did with great success until the collapse of CCB. Indeed, an underwriting had been scheduled for closing by Northland on the day after the fateful announcement of CCB's rescue program. Two months later a private debenture issue was made in the amount of $16M. The bank by this time had been classified in OIGB internal reports as "unsatisfactory". When the underwriters interviewed the OIGB about the condition of the bank, they were told that the OIGB was aware of nothing which would make it imprudent to proceed with the issue.

Management viewed the liquidity effect of the CCB collapse on their bank as a problem of market perception. They felt that the market expected them to take a large write-off of loans, and a proposal to do so was presented to the Government in July 1985. It was rejected. Governor Bouey saw no need for an asset restructuring to deal with an asserted liquidity, as opposed to a solvency, problem. Nevertheless the Inspector General, as a result of the CCB bailout, was becoming increasingly uncomfortable about the quality of Northland's assets, and accordingly desired to mount an inspection effort. The first results of that effort were available in August 1985, and revealed bizarre banking practices, overstated income, and overstated loan values. The Inspector General took the view that the only viable alternative for Northland was a merger. No government assistance would be advanced.

The National Bank was asked by the Inspector General to consider a merger with Northland. The staff of National examined Northland's loan portfolio, decided that its value was much overstated in the financial statements of the bank, and declined to consider the idea of merger any further.

By 1 September, the bank was insolvent by any reasonable standard. The Inspector General is required by the *Bank Act* to make a determination of this question. The Inspector General advised the Bank of Canada, which was still making liquidity advances to Northland, that the bank was no longer "viable". The Bank of Canada thereupon discontinued its liquidity advances. The Inspector General concluded that without these advances, Northland Bank was unable to pay its liabilities as they came due. The Inspector General thereupon recommended to the Minister of Finance that a curator be appointed. All this was done on 1 September.

A thorough review by the curator, assisted by Royal Bank personnel, confirmed that the bank was indeed insolvent. Many loans were classified as weak, doubtful, and bad. Employing a reasonable method of assessment, the curator concluded that additional specific loan loss provisions in the amount of approximately $190M would be required. Management and the Board of Directors had objected to the appointment of the curator, taking the view that management's approach of working with problem loans and assessing value over a longer period of time, in association with the bank's auditors, would best preserve the bank's assets. Accordingly, the bank was given time to attempt some rearrangement of its affairs. None came to fruition and a liquidator was appointed by the Court of Queen's Bench of Manitoba in early 1986.

That the recession in Alberta played a role in the failure of Northland Bank is undoubted. Its role, however, was secondary. It exposed Northland to a strain that management should have anticipated and should have included in their planning and operations. The poor quality of the loans in its portfolio was the primary condition which caused the collapse. The quality of these loans was exposed with the onslaught of the recession and the collapse was no doubt greatly accelerated thereby. The condition of the loan portfolio in turn was the product of inadequate lending practices and policies adopted by an inexperienced management. The continuous turnover in such experienced banking management personnel as the bank had been able to attract contributed to these troubles.

The activities of management from 1983 onwards did not so much cause the failure of the bank as the delay of that failure. The survival tactics put into practice in the last three years of the bank masked its true financial condition and forestalled for a time the inevitable realization in the market of the true state of affairs. All this is remarkable considering that the directors of the bank received in late 1982 an analysis of the bank which accurately described the bank's condition and foretold its fate. What makes this analysis the more remarkable is that the analyst produced his study from published bank statements and from some discussions with persons in the financial market in Calgary where the bank had its executive offices.

While acknowledging the energy, and indeed the courage, of senior management of the bank in the fiscal years 1984 and 1985 particularly, it must be realized that management crossed over the line of prudential banking and propriety in its efforts to keep the bank afloat. Loan warehouses were established to keep bad loans from reflecting their proper classification. One hundred per cent nonrecourse financing was commonplace. Lending practices became fee driven so as to sustain the income statement of the bank at a time when interest income was foundering. Other unconventional processes were introduced all to the same end: to present a financial picture which would not frighten off the depositors.

To do all this, management had to persuade two potential objectors to accept their tactics. One was the external auditor; the other was the Inspector General.

The auditors, through several consecutive fiscal years, accepted management's operational decisions and the method of reflecting these decisions in the bank's financial statements. Management's operational decision to place poor loans in workout was, in effect, understood by the auditors to require as a concomitant the accounting treatment proposed by management. This began some time in 1982. As the line of sound and prudential banking bent, so did the accounting treatment, until the bank's statements and reality no longer coincided. By the end of fiscal year 1984 the auditors had become, perhaps unwittingly, a part of the survival tactics of the bank. Their certification of the bank's financial statements was accepted by management and by the Inspector General as a validation by the accounting profession of management's processes in this period of dire straits.

The scale of these practices and the valuation consequences of the workout concept were known to the auditors. They accepted the accounting consequences as advanced by management without consequential objection. They did not follow the principles of bank auditing so amply described by the expert witnesses without any dissent from the other accounting witnesses. The auditors did not "stand back" and assess the overall condition of a loan portfolio extensively farmed out into workouts. They continued to accept management's explanations, which pushed recovery on the workout loans further and further into the future at each successive year end review. Some loans were entirely unproductive for several years. Interest continued to be accrued and no loss provisions were taken on these loans or on some loans where the borrower was in receivership. Sometimes the auditors raised a question; sometimes they did not; but they never prevailed in a meaningful way. In the end the auditors failed to bring to bear on their primary task, that of determining whether the financial statements of the bank as prepared by management fairly reflected the financial position of the bank, the principles of bank auditing prevailing in this country as described in evidence before the Inquiry given by qualified experts in this field.

The OIGB took the position that under the tripartite system of bank regulation, so long the practice in this country, they were entitled to and did rely upon the external auditors. If the auditors certified the bank's statements, the Inspector General assumed that the value of the bank's assets and the extent of its income were as set out in those statements. By this longstanding system, the Inspector General did not make his own assessment of the loan portfolio. Indeed, the size, organization and expertise of the OIGB staff indicates clearly that the system did not contemplate such action by the Inspector General. However, the Inspector General in fact went further. The Inspector General, from his own annual inspection and frequent visits to the bank, was clearly aware of all the practices of management already described. Survival tactics and future values were considered reasonable in the circumstances. The Inspector General recognized that the management of the bank was not "conservative" and was indeed dedicated, until very late in the life of the bank, to the practice of rapid loan growth. On one major confrontation of management by the external auditors the Inspector General did not provide any support to the auditors, though approached by them. Rather, he simply left it to management and the auditors to resolve their differences, and expressed satisfaction when they did so. There is no evidence that the OIGB ever determined the significance of the difference or the details of the compromise. The experience did not shake the faith of the OIGB in the financial statements which resulted.

Realization of the consequences of all this, both to the bank and to those persons dealing with the bank, did not appear to come to the OIGB until shortly after the collapse of CCB. The OIGB then began to refine its acceptance of the workout strategy and related value practices so as to impose a time limit on the endless recycling of loan recovery programs. The Inspector General only in 1985 began to call on the bank to recognize the gap that had grown up between asset values as stated on the balance sheet and as they appeared in market reality even on the bank's own files. The Inspector General, in the final analysis, places his reliance on the external auditors for all the information required for the regulation of the bank, but which here did not seem to reach the Inspector General. The Inspector General and his staff met frequently with management, but on 20 July 1985, when Neapole revealed the true state of affairs in the bank, the OIGB was little more prepared and little less surprised than on 14 March when they heard similar revelations from CCB management.

It is necessary in the face of the record compiled by this Commission to conclude that although the OIGB was in possession of all the information essential to a true comprehension of the state of affairs in Northland, awareness did not come. Even if it had, the will to respond was missing. It is a choice of losing alternatives.

The directors of the bank likewise relied heavily on others, this time the management. Little evidence was seen of challenge to management's actions. The directors, relative to the size of the bank, were active borrowers from the bank, but while their approval process of loans to directors bordered on the cavalier, this was not a discrete cause of the failure of the bank. The most serious characteristic of this Board, taken as a whole over the life of the bank, was its lack of anything approaching a detailed knowledge of the business of the bank. The bizarre (but in the eyes of bank management) crucial workout plans, some on a very large scale, were not fully comprehended either by the Chairman or by the Board members. The directors are responsible for policy and for management selection and direction. This Board was not, over the years, successful in performing these functions.

CCB

This was avowedly a bank which intended to become a national enterprise and not a regional bank. Unfortunately, taking the path of least difficulty, the bank opened up and largely stayed in Alberta and British Columbia where the commencement of business of CCB coincided with a large real estate and energy boom. It was easy to make large loans to a few borrowers on a rising real estate and energy market. Everyone in the community was realizing profits in these industries and CCB was anxious to participate in them. In the result, the bank became highly sectoralized and geographically confined in its lending. This realization came upon the bank with the advent of the recession and unhappily its expansion and diversification program into California and Eastern Canada coincided with the onslaught of the serious, long and deep recession in Western Canada.

Ironically, CCB may well have expired eventually by reason of its initial stunning success. In the Eaton years (1976 to early 1983), the bank, in the words of one of its long-term directors, was more successful by many standards and yardsticks of bank analysis than its peers, and indeed, than some of the major banks. Thus it was difficult for the directors to criticize the rapid growth policies of Eaton and some of his expansionist plans. The later serious trouble in the bank began with the aggressive lending practices and policies adopted by management in its early years which produced virtually overnight a large loan portfolio which later turned out to contain many accounts of extremely doubtful value. On his accession to the office of Chief Operating Officer, McLaughlan discussed in disparaging terms the state of the loan portfolio of the bank and the poor lending practices leading to that state in a memorandum to Eaton. He made reference to the "devastating proportions" of nonearning loans. McLaughlan concluded in retrospect that the seeds of the destruction of the bank had been planted in the loan portfolio prior to his succession to the office of Chief Executive Officer in early 1983. Indeed, he acknowledged that, in hindsight, the bank was doomed in 1983. The loans that were by then on the books of the bank were exposed to the wintry blasts of the Alberta recession which came in 1981. Bad loans made in the early years must be classified as a prime, long-term reason for the failure of this bank.

However, there are many other factors competing for this doubtful honour. One was the decision of management taken in 1981, approved by the Board, to purchase a minority interest in Westlands Bank, a California bank heavily involved in real estate lending. This was said to have been undertaken in the guise of a passive investment with a view to diversifying the bank away from its sectoral and geographic concentration but without involvement in active management. That the project was poorly investigated and ill-advised was the universal opinion expressed throughout the evidence. Ultimately, CCB as the parent company was required by the United States regulator, the FDIC, to clean up Westlands' poor loan portfolio, arrange for the infusion of further capital and better management, and generally to take steps to bring the bank back from its perilous state and restore it to financial health. In the end, this was indeed accomplished by compliance with the FDIC cease and desist order, but the price may well have been the death of CCB itself.

Two years earlier, the bank had opened a lending office in Los Angeles, CCB not being licensed to operate in California as a full bank. This branch of the bank engaged heavily in energy loans and by February 1985 had produced such an unstable portfolio of these loans (then mostly in a workout state) that an $85M write-off was suddenly revealed to be necessary. CCB management professed that this was the blow which brought down the bank. These weaknesses had been exposed by the U.S. regulator, this time the FRB, who told the bank, according to management's evidence, to clean up the loan portfolio in the Los Angeles branch or take it home to Canada. The California experiment amounted to a very high price for a failure in diversification.

At about the same time, Eaton appears to have become disenchanted with life in Edmonton in general and work at the CCB in particular. He became more and more remote from the Board of Directors. Eventually he caused the bank to acquire a home for him in Los Angeles where he intended to live while running the bank in Canada. To this the Inspector General properly objected and called upon the Board to take action. When Eaton visited the Inspector General to explain his strange conduct he apparently met with some success, because the record indicates that the Inspector General thought it reasonable to allow Eaton to remain on for a period of two years in order to find a successor.

In the meantime, Eaton had taken up a number of outside activities which eventually came to the attention of the Board, to its extreme annoyance, and led to a discussion of his relationship with the bank. Before the directors resolved the issue, the Ontario trust companies associated with Leonard Rosenberg were "seized". Eaton had entered into several business arrangements with Rosenberg, who in turn came to own or control almost 30 per cent of the outstanding shares of CCB. This was in violation of the *Bank Act* restrictions on ownership and CCB refused to register the offending transfers. The directors forced Eaton to resign. They thought it necessary to disassociate the bank from both Rosenberg and Eaton. Finding an investor to take over the CCB shares owned or controlled by Rosenberg required time, and continued to be an embarrassment to the bank in the financial markets. The Trust Companies Affair hung over the bank as a black cloud, probably for the balance of its life. The immediate impact on the bank was a loss of confidence and a run on deposits, driving the bank to the Bank of Canada for liquidity support. McLaughlan, Eaton's successor as Chief Executive Officer, did not, however, attribute to the Eaton experience the cause of the collapse of the bank.

The story of CCB is much the same as Northland's from this point in its life onwards. Bank management recognized the grave state of the bank and the serious risk it was running in carrying on in its present state. It was essential to shore up quickly the bank's income statement and to protect its balance sheet. To do so, resort was had to a technique of valuation of the loan portfolio which acquired the label in CCB of "baseline value". This valuation technique took into account future economic conditions in establishing the value of an asset in the present. All this was done, at least by September 1983, on a bank-wide basis under a directive which forbade the discounting or the bringing back to present value of those future values which were anticipated by management on the basis of an economic upturn of some kind at some indeterminate time in the future. With the support of this broadened valuation base, CCB proceeded to adopt the same operational and bank accounting decisions as did Northland in respect of income accrual, capitalization of interest and loan loss provisioning. These need not be repeated in this summary. All these strategies, from workout to accounting treatment adopted by management, were well known to the auditors of CCB, and the accounting treatment was carried into the financial statements which were ultimately approved unconditionally by the CCB auditors.

As the nonproductive loans, sometimes referred to as nonperforming, sometimes as nonearning and sometimes as marginal and unsatisfactory, rose in proportion to the total loan portfolio, the survival tactics adopted by management became more energetic and imaginative. Twin objectives became more and more apparent. The first was to obtain, if possible, fee income by one arrangement or another and thereby to buttress the income statement of the bank. The second was to establish by workout and security valuation an asset value which would forestall the necessity of taking a provision against the loan and enable the bank to continue interest income recognition. All this was for the same purpose, and had the same result as in Northland.

Again, management, either from conviction or necessity and very frequently the latter, were quick to find that principal and interest were ultimately collectable and that the value of the underlying security exceeded the principal and accrued interest of the loan. All this was done in the interests of postponing or avoiding indefinitely the classification of loans which would necessitate the taking of a loss provision. To do so would adversely and severely affect the income statement and balance sheet of the bank.

At least one dramatic development was uncovered in the evidence concerning CCB. Management had instructed all the branches of the bank to prepare a report on capitalization of interest in the bank for the years 1982 to 1984 inclusive. This report, duly signed by the various area managers, came in as requested and revealed in all about $59M of capitalized interest. Management, when faced with this documentation, attacked it as being inherently unreliable because, among other reasons, some of this recognized income was acceptable under prudent banking and proper accounting practices. Two difficulties for management at once arise. The first is that, even if the statement was 50 per cent in error, the amount of interest uncollected from sources outside the bank and taken by the bank into income over its last three fiscal periods, if reversed, would have eliminated all earnings during the period as well as all retained earnings in the bank. The second difficulty is that shortly after the bank staff had compiled this statement of capitalized interest, management, to comply with a request for information on the subject issued the same instructions as had earlier been issued to compile the study so vigorously attacked by them in the Inquiry hearings. The explanation given was that prospective compilation of a return of capitalized and accrued interest can accurately be done, but retrospective compilation requires too many judgments to make the resultant study accurate. There is, unquestionably, some truth in this response, but not enough totally to invalidate the information as a window into the conduct of the affairs of the bank from 1982 onward.

Another enlightening development is exposed by the evidence in connection with CCB's efforts to raise capital. This entailed the presentation to the investing public of financial statements which reflected a healthy, successful and profitable bank. Apparently to accomplish the presentation of such financial statements, the bank, commencing in the fall of 1983, set about to improve the nonperforming loan ratio in its financial statements by broadening the valuation base with all its consequential effects on the level of loan loss provisions and interest income recognition. The broadened valuation base would enable the exercise of the "management override" so as to continue the recording of income through the taking of accrued interest into the bank's income statement. All this was done because it had become evident to the bank and to its underwriters that disclosure of nonproductive loans would be required on a securities issue by the provincial regulatory agency. The Royal Bank had recently published a prospectus on that basis. The underwriter was assured by management that all this would be practicable because the nonperforming loan ratios would be improved. None of the measures taken by the bank to accomplish this result were disclosed to the underwriter or to the bank's auditors, although the auditors professed that it would have made no difference to them. This may indeed be true, because they were familiar in some detail with and accepted as appropriate the baseline value concept and other survival tactics adopted by CCB management. Nonetheless the underwriting proceeded and the securities were sold on the market with a prospectus which included financial statements certified by the auditors and in which there was nothing to indicate that in the preparation of these statements, the bank had adopted any collateral security valuation measures different from those used in the preceding year or which would have the effect of reducing the ratio of nonperforming loans in the loan portfolio of the bank. The prospectus was approved by the OIGB under the *Bank Act*.

As in the case of Northland, the practices adopted by CCB and accepted by its auditors relating to valuation of assets, capitalization and accrual of interest and the taking of loan loss provisions, were, according to the evidence taken by the Inquiry, contrary to banking practices in the six largest Canadian banks. Furthermore, the evidence reveals that these practices were not in compliance with the bank accounting principles described in the evidence given by bank auditing experts.

The position of the auditors vis-à-vis these operational decisions and management's decisions of the appropriate accounting treatment is much the same as in Northland. The auditors, in approving the financial statements of the bank for the year 1984, and most likely the year 1983 as well, failed to apply the bank auditing practices and procedures as described in the evidence before the Inquiry by the professional bank auditors.

The dependence of the Inspector General on the external auditors and on management as part of the tripartite supervisory system is again the same in the case of CCB as in Northland. The magnitude of the degree of this reliance is dramatically revealed in the evidence relating to a complaint made to a law enforcement agency concerning certain practices in CCB. The essence of the complaint was that management had directed the bank staff to introduce for improper purposes the asset valuation process already discussed. The law enforcement agency attended at the OIGB, revealed the complaint, and inquired as to the position of the Inspector General. In due course, the OIGB advised the law enforcement agency that, inasmuch as the financial statements for the year in question had been approved by the external auditors, there would be no reason for anyone to investigate the adequacy of the asset valuation process. The OIGB did nothing to investigate the matter and did not advise the auditors of the complaint, nor was legal advice taken.

The Inspector General was aware of the baseline value concept, the workouts, and the active operational and accounting practices adopted by the bank. He shared management's general survival tactics because, like management, he hoped throughout this period that the Western Canadian economy would revive and thereby cure the ills of the bank. It turned out that the economy did not revive, and the Inspector General was faced by a bank with a bleak future. All this was realized by early March 1985, but by then, the Inspector General had foregone any opportunity to intervene. Even then, it may not have been recognized how formidable the problem had become. By then, the Inspector General could offer no solutions.

The Board of Directors must share some responsibility as well for the failure of the bank. They were susceptible to being mesmerized by management, and realization of the true state of affairs and its ramifications came too late. The key is their failure to insist upon simple and straightforward information from management. However, the complex interaction of other forces and the actors, management, auditors and the OIGB, makes it difficult to classify any act or omission on the part of the Board as being an independent cause of the ultimate failure of the bank. The responsibility of the Board, which acts through a dynamic, shifting majority, as in the case of Northland, defies summarization and the reader is encouraged to refer to appropriate sections of the report.

By the end of fiscal year 1984, the management tactics described above had brought about a number of unfavourable results. The financial picture presented by the financial statements did not reveal all the weaknesses in the bank. This forestalled the arrival of discernible insolvency, thereby increasing the cost of ultimate failure to all concerned. Any investors and depositors who relied on the financial statements regarding important matters, principally the state of the loan portfolio, would have been misled. Finally, the obfuscation of the financial statements produced by the survival tactics interfered with a complete understanding of the state and needs of the bank by the participants in the support program, and may well have defeated the attempts of all concerned to save the bank or make a sound decision as to whether or not to stage a rescue attempt.

The bailout or support program of the CCB commenced with McLaughlan's revelations to the OIGB and to the Bank of Canada on 14 March 1985, of the inability of the bank to continue in operation without outside assistance. By 25 March, a government and banking industry supported bailout program had been put in place and announced to the public. The program suffered from many defects brought on by a number of conditions existing at the time. There was no well-defined regulatory framework in the statutes providing for this type of event in the banking community. The Bank of Canada, without the necessary statutory position or staffing, was thrust into the position of leadership in the design, implementation and execution of the program. The information laid before the meeting of government agencies and leaders of the six major Canadian banks by the Inspector General was inadequate for the guidance of the meeting in the decision to rescue the bank or to allow it to fail. The time limitation of one weekend placed an impossible limitation on the meeting, if it were hoped that a workable rescue program could be evolved before the bank was required to resume operations on the following Monday. As it turned out, the program contained a number of flaws which contributed in varying degrees to the slide of the bank into, or further into, insolvency. The failure of the CCB bailout should not, however, preclude the use of rescue techniques when proper circumstances arise in the future.

The OIGB, by reason of its position in the statutory pattern for the regulation of banks, must bear much, but not all of the blame for this condition and for what transpired. As mentioned earlier, the Inspector General was aware of the state of the bank and failed to act. Further comment must be made regarding the OIGB performance in the bailout. The information concerning the health of the bank, and the state of the loan portfolio in particular, was inadequate. Inspections instituted just prior to and during the meeting were not coordinated or well-organized, and the outcome of these loan examinations was incompletely or imperfectly relayed to the meeting. Efforts by the OIGB thereafter to examine the loan portfolio were spasmodic and ineffective until very late in the day when the Hitchman team was dispatched. The monitoring of the rescue program was ineffective, and in the result no adaptation of the program to the unfolding situation was ever brought about. The caution on the part of the Government occasioned a delay in formulating Government policy regarding the contribution of public funds. The limits of responsibility in the Ministers must be to ensure prompt discharge by the public officials of their statutory duties. Here, this principally relates to the Inspector General. Apart from a delay in formulating government policy as to the intervention with public funds in a rescue program of the bank, and a tardiness in responding to the request of the major banks for a detailed and comprehensive loan portfolio assessment, there is no reasonable criticism to be levelled at the responsible Ministers, and none was directed at them in the testimony. Proper caution in the use of public funds rather than "bargaining brinksmanship" with the big banks appears to account for the time taken by the Government for decision. The Ministers reasonably relied on their principal advisor, the Inspector General.

The evidence clearly indicates that the Hitchman Report revealed to all concerned that the true state of the assets of the bank was seriously different from the representation of those assets in the financial statements of the bank. Considerable evidence was directed at this report and some indicated serious inaccuracies in some parts of it. The conclusion as to asset quality was attacked but only on the issue of degree. Even if the assessment of the value of the bank's loans was only 25 per cent correct, the bank's capital had disappeared. McLaughlan accepted the fact that the bank was indeed insolvent on 1 September. The final Hitchman Report was delivered on 13 August. The Governor of the Bank of Canada recognized all this in a discussion with the Minister of Finance when he stated that the Support Program was devised without the knowledge of the CCB loans which was later acquired. The Inspector General agreed that the Hitchman Report was the turning point in his understanding of the state of the bank's loan portfolio. Perhaps the greatest significance of this report is the light it sheds upon the ineffectiveness of the external auditors and the OIGB in discharging their respective functions in the years leading up to the failure.

In the end, the bank failed with the rescue program still in place. The rescue failed because the plan was neither scaled nor attuned to the true state of the losses suffered in the bank's loan portfolio. Had the magnitude of the losses been known, the rescue program may never have been attempted.

All depositors were compensated fully (beyond their insured limits) no doubt because of the announcements made by public officials at the beginning of and during the rescue program, for the purpose of supporting that program by attempting to restore confidence in the bank in the financial markets and in the community generally.

Recommendations

From all the evidence describing the various events in both banks, certain clear lessons can be derived. These lessons in turn have led the Commission to make the extensive recommendations found in Chapter 6. The banking industry recognizes and the evidence taken in the Inquiry supports the importance of the continuance of the tripartite supervisory system, modified to recognize the need for some direct examination by the supervisor of the quality of a bank's loan portfolio, particularly where a bank is emitting trouble signals. This recognizes some of the benefits of the hands-on supervisory system, but only as a supplement to the basic tripartite supervisory process. It is also recommended that a power to issue cease and refrain orders be added to the regulator's arsenal. The only current statutory sanction possessed by the regulator is the power to direct that a bank maintain certain levels of liquidity and capital. OIGB officers have testified that this power is neither expeditious nor feasible in all cases. The current "wink and nod" system of regulation should be reshaped and strengthened. The essential recommendation is that the supervisory function should be placed within a framework which will contribute the primary element revealed by these events to be missing: the will to respond when the signals of trouble in a bank come to the regulator. The proposal is that the OIGB be integrated into a reorganized CDIC. The insurance function and the inspection function would be combined. It is noted that the slow trend in the United Kingdom is away from a consolidation of the inspection service with the central bank, an alternative which the Commission does not recommend here. The insurance and inspection functions are combined in some U.S. agencies, notably the FDIC.

The present functions and staff of the OIGB would be transferred to the CDIC, including the duties of supervising banks and approving prospectuses associated with the public offering of bank securities. The new regulator would be organized as a Commission of three full-time appointees, one from the bank auditing profession, one with senior management experience in the banking business and the third from the insurance business or from the business community at large. The predominant characteristic of the bank regulatory function is administrative. The policy elements relating to establishment and termination of banks should be left with the executive branch, here represented by the Minister of Finance. The Crown corporation instrument is less appropriate to the administrative regulatory role. For these reasons a full-time professional Commission is recommended.

It is the view of this Commission that such an organization, which might be called the Canadian Deposit Insurance Commission, will bring to bank regulation the necessary skills and experience to establish a procedure whereby troubles in a bank will come to the attention of the regulator in a timely fashion. Perhaps of even more importance, this recommendation is founded in the belief that a regulator so organized will have the interest, the will and the skill to respond quickly to troubles in a member of the banking industry, in time to head off ultimate collapse by rescue programs, mergers or other means. It should be added, however, that in all communities where comparable banking institutions have been established, it has been recognized that a regulatory system should not be constructed so as to assure that all banks will be saved whatever the cost may be to the community.

When so reorganized, the regulator should, in the recommendation of this Commission, be the agency primarily responsible for the design and implementation of a bank assistance program designed to ensure the survival of a bank which, in the view of the Minister of Finance, should in the public interest be saved. The provision of liquidity advances would remain in the Bank of Canada but the procedure would be revised, when it has been determined to assist a bank facing long-term liquidity or insolvency problems, so as to center the responsibility for the operation of the program in the regulator. Solvency funding would be organized by the regulator and provided from its own sources, from the banking industry where circumstances warrant, or through loans from the Bank of Canada or the Government of Canada. Upon the success of the bank assistance program, the regulator, with the authority of the Minister, would restore the bank to private ownership. In order to ensure that public funds are not deployed for the purpose of restoring value to the capital investors in a bank whose capital has been lost by the bank, a procedure is recommended whereby the outstanding capital, debt and equity, as defined by statutory amendment, of a bank may, under a bank assistance program, be reduced or cancelled, with compensation ordered by a superior court where it can be demonstrated to the court that the bank was not actually insolvent, or facing imminent and inevitable insolvency, at the date of the bank assistance program. The bank assistance program may include the offer of the opportunity to existing capital investors of the bank to contribute, together with, and on the same basis as the regulator and perhaps others, new capital in the reorganized bank.

The recommended organization for the bank regulator would be sufficiently broad in scope to embrace eventually the delivery of its services to other federally established deposit-taking institutions as well as like provincially established institutions where the provinces so desire.

A number of accounting principles have been examined before the Commission, and a series of recommendations with respect to those proposals is likewise contained in Chapter 6. For the purpose of establishing an ongoing and productive relationship between the banking regulator, the banking industry, the bank auditing profession, and the accounting profession in general, it is recommended that an Advisory Committee be established to assist the regulator on these matters. Its members should be appointed by Order in Council and should be drawn from the bank auditing and general accounting professions, the legal profession and the banking and insurance businesses.

It has been 60 years since this country has experienced a bank collapse, although less serious episodes have culminated in bank mergers. There have also been in those years a number of failures of other financial institutions which involved the regulator of banks, through the CDIC. Whether or not it should have been, this lengthy period of time no doubt was a factor which may have lulled the regulators, the external auditors, and indeed members of the banking community itself, into a false sense of security.

It should be remembered that these events concerned only a tiny fraction of the Canadian banking business. Public confidence in the banking system should not be shaken by these events, but the country should respond to them by improving the banking supervision system. Such a system should be designed so as to reveal to a responsive regulator on a timely basis weakness in a bank, and so as to ensure that banking as an institution will continue to render banking services throughout the country on an economic, efficient and safe basis. The regulatory system should be such as to ensure the maintenance of competitive practices in the banking business and that when opportunities properly present themselves, new entries into the banking system may be permitted. These ill-starred experiments in no way suggest that there is no place in the community for new banks or for the use of bank support programs in proper circumstances.

All the conclusions of this Commission have been reached upon the record established from testimony and documents examined by the Commission. It may be that other forums and tribunals faced with different rules of evidence and having different objectives will reach different conclusions with respect to duties and obligations of the participants in these events.

Chapter 2

Scope of Inquiry

The Inquiry was convened by Order in Council P.C. 1985-2932 on 29 September 1985. The Commission assembled a small staff of lawyers, an accounting advisor, a Secretary and secretarial staff and undertook hearings which commenced in Ottawa on 2 October 1985 and concluded in Calgary on 22 May 1986. Written submissions by participants and from the public continued to be received until early August 1986.

Terms of Order in Council

The Inquiry was directed to inquire into and report on:

> ... the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank including
>
> (a) an examination of all the circumstances and factors contributing to the condition of the banks and resulting in the cessation of their operations; and
>
> (b) regulatory action in dealing with these conditions and circumstances taken by the Government of Canada and its agencies, including the Bank of Canada; ...

The Order goes on to direct the Commission, if it:

> ... concludes that the circumstances so require, to recommend any changes in the regulatory and administrative control of the banking industry in Canada that the experience of the matters reviewed in the course of the inquiry may show to be necessary or advisable.

These terms of reference have not been found by the Commission to be restrictive. The Commission proceeded to conduct public hearings after notice was published in the newspapers in Ottawa, Calgary, Edmonton and Vancouver. It was immediately realized by the Commission and all parties appearing before it that some unusual characteristics attached themselves to these proceedings. The very nature of banking itself necessitated the adoption of some special procedures. Public confidence is one of the prime prerequisites to the survival of a bank, and indeed a banking system. Even the fact of a public investigation of a bank is unsettling to the financial community. Because public interest in banking is high, the daily reporting of evidence at the hearings represented a constant concern, if not a threat to the well being of other banks, particularly those other than the major Canadian banks, sometimes referred to as the "Big 6".

A second matter of prime importance at once became evident. This investigation reflected directly on the welfare and careers of a number of individuals in the staff of these two banks, their directors and auditors, persons engaged in the public service in regulating these banks or conducting related activities, underwriters, and others. Perhaps of even greater concern was the need to protect the private affairs of those customers of these banks who were caught up accidentally and incidentally in their liquidation. Accordingly it was necessary to establish a process whereby the Commission could fully discharge its mandate and at the same time minimize any adverse affects on other banks and individuals affected.

From the outset the thousands of pages of documents entered as exhibits were reviewed and all references identifying borrowers, and others who happened to be dealing with these institutions at the time, were expurgated. Full cross-examination was permitted, but without the right to know or to reveal (if somehow ascertained) the deleted identities. Sometimes this process required additional deletions to prevent improper disclosure. Witnesses were interviewed and documents were examined by Commission counsel in advance so that all information affecting other banks and other people and institutions could be deleted where it was in the public interest to do so and where it did not impinge upon the discharge by the Commission of its responsibilities. It is a tribute to the great number of counsel appearing before this Inquiry that none of these confidences were ever breached. On one occasion, by accident, the identity of persons in high office in another bank was revealed in an exhibit. It is a great credit to counsel and more particularly to the financial press, who reported on the Commission's hearings daily and in great detail, that this slip was never repeated or made the subject of comment by counsel on the record. The detailed, laborious work by Commission counsel and its legal staff is acknowledged with gratitude by more than the Commissioner.

During the course of the investigation, the Commission heard evidence or received submissions from eighty-five individuals. The witnesses appearing before the Commission included management, directors, auditors and liquidators of the CCB and Northland Bank, senior representatives of all the major Canadian Schedule A banks, and officials or representatives of the Office of the Inspector General of Banks, the Bank of Canada, the Canada Deposit Insurance Corporation, and the Department of Finance. The Minister of Finance and the Minister of State (Finance) also testified before the Inquiry. Provincial regulators and underwriters associated with the approval, issuance and exchange of bank securities appeared before the Commission to present information. In addition, the Commission heard from industry representatives, and other experts on particular aspects of the banking industry and the economy of Western Canada in the 1980s. In recognition of the fact that arrangements for the supervision of banks have recently been under review in other jurisdictions, the Commission also heard from experts familiar with the regulation and supervision of banks in the United Kingdom and the United States. Several individuals submitted briefs or memoranda to the Inquiry; a number of these persons appeared before the Commission during the course of its hearings. Individuals who testified during the Inquiry or who made submissions are listed at the end of the Report. For convenience, individuals are referred to in the report by surname only after first being introduced in the report.

When hearings began, the Northland Bank had not been placed in liquidation by the courts of Manitoba (this did not occur until 20 January 1986). Consequently, the evidence surrounding the collapse of CCB was examined first. This examination included the rescue program initiated by government and banks which ended with the appointment of a curator for the CCB on 1 September 1985. Thereafter general regulatory issues, and the process of bank supervision in this country and in the United Kingdom and the United States, were examined. Finally, the evidence leading to the failure and liquidation of Northland came to be considered.

The hearings were conducted in Ottawa during October, November and December 1985, and again in January, February and May 1986; in Edmonton in November 1985; and in Calgary in March and May 1986. The banking and accounting witnesses in the United Kingdom were examined during the Ottawa hearings by two-way satellite television. Experts in United States bank regulation appeared in the Ottawa hearings. In the end some 14,000 pages of evidence was transcribed at these hearings.

At the request of the journalists, both print and broadcast, the Commission permitted the installation of television audio and video facilities in the hearings in all three cities. This was said to provide economies and efficiencies to the journalists and to place all of them on an equal footing. The system worked well and the public interest appears to have been served, and certainly was not injured, by this process.

The issues, which at once arose and remained before the Commission throughout, related to the management of these banks and to systemic matters as well. The role of senior executives, directors, auditors, public regulators, the Bank of Canada, the CDIC, the Ministers of the Crown, the Department of Finance, and the underwriters of bank security issues, all came in for detailed examination in both evidence and argument. All this was done in public hearings except for some procedural sessions with counsel of all parties which were conducted *in camera* in order to avoid unnecessary revelation of confidential information affecting persons not involved with the issues raised in the Inquiry.

It was necessary throughout the hearings to make it known to the participants and to the community at large that the Inquiry was not a convenient forum for the trial or settlement of all issues, public and private, arising out of these failures. A distinction was drawn and maintained throughout between the inquiry process and the trial of rights, duties and differences in and among persons who considered themselves affected by these events. The Commission functioned only in the discharge of its prescribed mandate; all conclusions reached are based only on the evidence gathered by it. Other forums at other times with different roles in our society might have occasion to consider some of these same events. These forums would do so under different rules of evidence and procedure. Such forums may indeed reach different results on their own records of evidence. Such is the basis of our judicial system and of the rights of free citizens to take their differences and grievances to court. It was one of the overriding concerns of this Inquiry to do nothing which might jeopardize such rights and any such proceedings. The Commission is indebted to all who appeared before it for their recognition of this distinction and this principle, and matters were not delayed or prolonged by any attempt to use the Commission for other or improper purposes.

Work of Other Bodies

The Commission derived great assistance from the opportunity to read the transcripts of the proceedings and reports of other bodies, Parliamentary, commission and otherwise. These are listed in Chapter 6. Again the objects and purposes of these bodies were quite different from those of the Inquiry. Matters of a general regulatory nature came up frequently and the work of others on such matters saved this Inquiry much effort and time and afforded helpful guidance.

Appendices

In the course of its deliberations, the Inquiry assembled a great body of fact and information about these two banks, their inspection, operations and ultimate collapse. It also accumulated a very large record concerning the supervision and reports of these banks from the public authorities. It was seen to save counsel time and effort to assemble, collate and distribute to counsel the details and outlines of this evidence at the conclusion of hearings and before argument. This was also hoped to clarify and expose the issues arising from all of these facts and thereby reduce the time required for the hearing of final argument. The Commission received suggestions for modifications of these collations from counsel appearing before it. These were considered, and accepted where it was felt appropriate. The summaries were then expanded in scope to provide background detail to those so interested. These summaries are found in Appendices C, D and E.

Similarly, the history of bank regulation in Canada was reduced to a summary which appears as Appendix A. Appendix B is a summary of the information compiled by the Commission on the supervisory and regulatory systems in the United Kingdom and the United States, and contains some reference to the treatment of similar bank failures in those countries. By a coincidence which was helpful to the Commission, but which could not everywhere be called a happy one, bank failures occurred in both the United Kingdom and the United States just before the failures here, and they followed a pattern and timetable remarkably similar. The Commission has drawn heavily on these vicarious experiences in communities not dissimilar to ours and, as will be seen in Chapter 6, has drawn upon some of the information and lessons found in Appendix B. Appendix F describes the expert evidence heard by the Inquiry about banking practices and the auditing of credit decisions. This appendix contains information upon which some of the recommendations are based.

Recommendations

All associated with this Inquiry have acknowledged throughout that its mandate carried it into a study of only about one per cent of the total Canadian banking industry. These were two small banks which had reached a state of development that had not carried them to national stature by the time of their liquidation. Conclusions built on this narrow base cannot be extended without caution and qualification to the whole banking scene. The major banks have come forward and discussed fully all the issues raised in this Inquiry, but of necessity, largely in the context of these two liquidations which formed the basis of the Inquiry's mandate. It is only the concluding part of that mandate that carries the Inquiry into broader issues of bank supervision and regulation.

In this aspect of the investigation the Commission was fortunate to have the evidence of Mr. William H. Broadhurst, a senior member of the Price Waterhouse executive in Canada, and an acknowledged leader of eminence amongst auditors, with bank audit experience over many years in this country; Mr. Alan J. Dilworth, nominated as its spokesman by the Canadian Institute of Chartered Accountants, a senior partner in Touche Ross, and a leader in the Canadian accounting profession; and Mr. Michael A. MacKenzie, a senior partner in Clarkson, Gordon, a firm long important in accounting and auditing in this country and himself an auditor with long and distinguished experience in the auditing of banks. It is with this outstanding assistance that the Commission is able to respond to a very important part of its mandate and to report upon some of the fundamental aspects of bank auditing and accounting that have been raised in these hearings. This support from the leaders of accounting and bank auditing was also essential to formulate a considered response to the great number of proposals made by the banking and accounting profession to this Commission. These matters form part of the recommendations in Chapter 6. These presentations by auditors, the major banks and the several government agencies were detailed, comprehensive and thought-provoking. The questions posed and answers proffered them provided much of the basis of the Commission's response to the second part of its mandate.

In the course of the Inquiry, the Commission was asked to exercise its powers under the *Inquiry Act* and defray the legal expenses of some parties who considered it essential to their self-interest to meet any statements and references made in the course of the Inquiry hearings which were perceived to be against their interests. Some requests were rejected outright and others were set aside until the Commission could be satisfied that it was important to its work to have the party in question present and represented by counsel, and that fairness justified compensation for reasonable legal expense. Eventually arrangements were made, with express limits, for the former senior management of the two banks to be represented by counsel on this basis during the concluding part of the Inquiry.

Some matters were raised in respect of which the Commission declined to take evidence or to hear submissions. Other matters, such as the competing interests between provincial securities exchange regulators and federal bank regulators, were dealt with incidentally to one of the main issues: the adequacy of response in the supervision of these banks by the office of the Inspector General. Still other matters, such as deposit insurance limits, were clearly not within the mandate but were the subject of several serious proposals. The Commission expresses its views on these matters to the extent that they were the subject of evidence so that those directly concerned with such matters would be aware of the record accumulated by the Inquiry. Finally, the influence of a policy of full insurance coverage on the element of self-discipline by creditors of the bank and on the practice of aggressive deposit-raising tactics by banks is discussed as being within the perimeter of the Order in Council.

The Scene in Western Canada during the Career of these Banks

The Inquiry opened with a great avalanche of evidence concerning the extent and depth of the recession in Alberta and British Columbia. This was to be a subtheme throughout the hearings. The expert evidence was all relevant to the issues and demonstrated a phenomenon not limited to Western Canada.

> Through the 1970s and into the early 1980s, few ... expected the good times to end. Employment growth during the 1970s was double the national average. Perpetual prosperity was at hand.

This sounds like Alberta but was written in July 1986 about banking in Colorado, a region not unlike Alberta. A great many other factors remained to be investigated but the intervention of a partly induced, partly cyclical economic slow-down in the tradition of the principal commercial and industrial activities of the region, formed a foundation upon which this drama was played out. What follows is a study of the relationship between this background condition and the many other elements in the story of these two banks.

Chapter 3

Banks and Bank Supervision in Canada

A. Introduction

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C. External Auditors

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E. Department of Finance

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Chapter 3

Banks and Bank Supervision in Canada

A. INTRODUCTION

To appreciate fully the evolution of circumstances leading to the cessation of operations of the Canadian Commercial Bank (CCB) and the Northland Bank, it is essential to examine the basic components of the Canadian banking system and to understand the overall framework of Canadian bank supervision and the responsibilities of those involved at all levels of the Canadian supervisory system. Those involved include various officers and directors of the two banks whose collapse has been the principal focus of this Inquiry, several audit firms engaged by one or other of these banks in recent years, federal agencies and officials with statutory authority relating to all aspects of banking from inspection to investor or depositor protection and provincial agencies concerned with the issuance of and trading in bank securities. Certain U.S. regulatory authorities were also involved in supervisory activity relating to the CCB.

The evolution of Canadian banking and bank regulation is a complex and continuing process. Readers desiring further information on the historical background are referred to Appendix A of this Report. More detailed information concerning the United States and United Kingdom banking regulatory systems, including recent proposals for change, is set out in Appendix B to this report. References to these systems are hereafter made for comparative purposes and to assess some of the proposals which have been made for the improvement of Canadian banking regulation. Recommendations by the Commission for changes to current Canadian regulatory arrangements are presented in Chapter 6.

B. BANKS

1. Overview of Canadian Banking Industry

The *Bank Act* governs the operation of the Canadian commercial banking system. Since 1980 the legislation has provided for two kinds of banks known, according to their designation in appendices to the statute, as Schedule A or Schedule B banks. Only these institutions are "banks", and allowed to describe their business as "banking".

The distinction between Schedule A and Schedule B banks is established by s.5 of the Act. A Schedule B bank is a closely held bank without restriction on the number of shares held by any one person, Canadian or non-Canadian, resident or non-resident. Schedule A banks are widely held: no one may hold more than 10 per cent of the voting shares, and not more than 25 per cent of any class of shares may be held by non-residents. The letters patent or special act establishing any bank provides whether it is an A bank or a B bank. Certain restrictions have been placed upon B banks. For instance, B banks may not, without specific authorization, have more than one branch office and all branches must be in Canada; they may not have domestic assets exceeding 20 times their capital if the voting shares held by one person, or by all non-residents, exceed 10 per cent of all issued voting shares; and foreign-owned B banks may not own collectively more than 16 per cent of the total domestic assets of all banks in Canada.

At 31 October 1984, the last financial year for Canadian banks prior to the cessation of operations of the CCB and Northland Bank, thirteen Schedule A banks were in existence. These banks are listed in Table 3.1 together with information concerning their authorized capital and head office location.

Table 3.1

SCHEDULE A BANKS

Form of Name of Bank	*Class of Shares*	*Authorized Capital (Dollars)*	*Head Office of the Bank*
Bank of Alberta	Common	50,000,000	Edmonton
Bank of British Columbia	Preferred	75,000,000	Vancouver
	Common	250,000,000	
Bank of Montreal	Class A Preferred	1,000,000,000	Montreal
	Class B Preferred	250,000,000	
	Common	200,000,000	
The Bank of Nova Scotia	Preferred	1,000,000,000	Halifax
	Common	1,500,000,000	
Canadian Commercial Bank	Class A Preferred	100,000,000	Edmonton

Table 3.1—*Concluded*

Form of Name of Bank	*Class of Shares*	*Authorized Capital (Dollars)*	*Head Office of the Bank*
	Class B Preferred	1,000,000,000	
	Common	100,000,000	
Canadian Imperial Bank of Commerce	Class A Preferred	750,000,000	Toronto
	Class B Preferred	750,000,000	
	Common	3,000,000,000	
Continental Bank of Canada	4 1/2% Pref.	3,500,000	Toronto
	5 3/4% Pref.	11,500,000	
	Class A Preferred	150,000,000	
	Common	100,000,000	
The Mercantile Bank of Canada	Class A Preferred	100,000,000	Montreal
	Class B Preferred	100,000,000	
	Common	100,000,000	
National Bank of Canada	First Pref.	300,000,000	Montreal
	Class A Convertible Preferred	49,600,000	
	Class B Preferred	300,000,000	
	Common	100,000,000	
Northland Bank	Preferred	35,000,000	Winnipeg
	Common	100,000,000	
The Royal Bank of Canada	First Pref.	1,250,000,000	Montreal
	Second Pref.	1,250,000,000	
	Common	3,000,000,000	
The Toronto-Dominion Bank	Class A First Pref.	625,000,000	Toronto
	Class B First Pref.	625,000,000	
	Common	2,000,000,000	
Western & Pacific Bank of Canada	Common	21,000,000	Vancouver

Fifty-nine Schedule B banks came into existence between the time of the authorizing legislation in 1980 and financial year end at 31 October 1984. Only one of these Schedule B banks was a domestic bank. In 1985 it merged with another Schedule B bank.

2. Internal Operations and Statutory Responsibilities

a. *Directors and Officers*

The *Bank Act*, in addition to establishing the legislative basis for the formation of banks in Canada, contains provisions respecting their operation. These provisions confer certain powers and impose duties on persons associated with bank management. Subject to the *Bank Act*, the directors are to manage the business and affairs of a bank. The *Bank Act* does not specify minimum or maximum numbers of directors; nor does it require the board to include representatives of particular groups or constituencies.

The directors are required to designate one of their number as chief executive officer and, where authorized by the by-laws, may appoint committees of the board and may delegate to those committees any of their powers other than certain specified powers. It is the responsibility of directors to appoint officers to carry out the functions of a chief manager, a chief accountant and other officers to conduct the business of the bank. It may be said, in general terms, that the purpose of the board is to arrange for adequate management and to provide for its continuity, to represent the bank publicly, and to serve as the final policy-setting body of the bank. The day-to-day operations of the bank are carried out by management. In some banks, it is felt that the main burden of the directors' role is more effectively discharged by an executive committee which is able to meet more frequently than the full board.

In addition to an executive committee, the board may appoint other committees and is required by statute to appoint an audit committee. (The functions of this body are described below.) Regional committees have also been used to monitor and guide bank performance on a regional basis. Loan committees have been established at most banks. The mandate of a loan committee is typically to review all loans outside management lending limits, the bank lending policy, the loan mix, out-of-order loans, loans in arrears and all other related credit matters. The minutes of all meetings are circulated to the other directors. In some banks, the loan committee has delegated to it the full authority of the board to approve loans. In other banks, including the CCB, the loan committee possesses a certain lending limit, and the board itself possesses an even higher lending limit. It may also be the function of the loan committee to review loans above a specified amount, even such loans as were made within management lending limits. There are, however, banks which have very little delegation to committees of the board. It is clear that in Canada there is no standard pattern for the location in the corporation of the authority for loan approvals by management, or by the board or its committees. Nor is there any uniform process in Canadian banks for the monitoring of trends in relation to the control and management of the loan portfolio of the bank, except that in the major banks all board members are informed on a regular basis about the significant elements making up the loan portfolio.

In exercising their powers or discharging their duties, directors and officers are subject to a statutory duty of care owed to the corporation. Section 54 provides that they must "(a) act honestly and in good faith with a view to the best interests of the bank; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." The *Bank Act* also provides, however, that a director who relies in good faith on "(a) financial statements of the bank represented to him by an officer of the bank or in a written report of the auditors of the bank fairly to reflect the financial condition of the bank; or (b) a report of an accountant, lawyer or other person whose profession lends credibility to a statement made by him" is not liable for failure to discharge the duty of care.

Considerable importance is attached to the timely and reliable flow of information to directors. For example, an exhibit filed by the Bank of Nova Scotia indicated that directors of that bank receive the following information on a regular basis: the nature of the loan portfolio, reports on nonperforming loans and on all significant loans which are causing concern, statistics as to loan losses in regions, industries and classes of business, the nature of the funding of the bank, comparisons as to performance with other banks over relevant periods of time, and reports as to the performance of the national economy and its components.

b. Internal Inspection Systems

By their nature, banks are exposed to several major threats to the accurate reporting of financial results. These include recording and aggregation errors, inability to recover full value of all loans, taking interest and fees into income before receipt, and incorrect valuation of trading assets and liabilities such as foreign exchange. Canadian banks have developed control structures to monitor and respond to these risks. It is the internal inspection department which tests the reliability and operation of these control systems. The purpose of the inspection division is to provide the board and senior management of the bank with an independent perspective on the operations of the credit department and its loan authorization and loan management functions. Thus, the internal inspection division has two functions; to audit the quality of loans and to audit the bank's control structures. In some of the major banks these two functions are contained in the one department and in others they are separated.

Although operationally part of management, the chief inspector of a bank and the internal audit staff enjoy a measure of effective independence which leaves them somewhere between the board of directors and its audit committee and line management of the bank. This system, with variations in the individual banks, and while not required by the *Bank Act*, has become a part of the traditional structure of Canadian banks.

Particular practices as to the duties and organization in internal inspection departments vary from bank to bank. Thus the Bank of Nova Scotia has an internal audit system whose chief officer reports to the President but has a directive that if anything comes to his attention that is not satisfactorily resolved, it must be referred to the CEO, and beyond him, to the Chairman of the Audit Committee. All credits of $1,000,000 and over are examined by the senior credit audit department. At the Canadian Imperial Bank of Commerce, the Chief Inspector brings situations with which he is concerned to the attention of the Credit Division but he also has direct access to the Chief Executive Officer and direct access to the Audit Committee. He is instructed as part of his mandate to report to the Audit Committee and is regularly invited to attend at the Audit Committee. Evidence given by senior officers of other major banks demonstrates a comparable emphasis on the position of the Chief Inspector and the importance of his contribution in ensuring that a bank is not confronted with sudden surprises which threaten its financial stability. As Mr. Frazee, then Chairman of the Board of the Royal Bank, testified, the internal inspection department is the reason he could sleep at night.

c. *The Audit Committee of the Board*

In the absence of a Ministerial order providing an exemption, the *Bank Act* requires the directors of a bank to appoint an audit committee of the board. The audit committee is composed of not less than three directors. No member of the committee may be an officer or employee of the bank or any of its affiliates. The statutory duty of the audit committee is set out in s.243(3):

> The audit committee of a bank shall review the annual statement and any other financial statement of the bank that may be required by the by-laws to be submitted to the shareholders before such statements are approved by the directors.

While the establishment of an audit committee of the board is mandatory, the procedures followed by that committee vary between banks. Traditionally, it is the role of the committee to ensure that the bank has processes in place that ensure the production of accurate and reliable data, and to ensure that those procedures are functioning. The Chief Executive Officer of the Bank of Nova Scotia testified that the Audit Committee of that bank reviewed the internal control system of the bank, its loss provisioning and the management letter which the auditors customarily provide to the bank in connection with their annual audit. The auditors of the Bank of Nova Scotia present to the Audit Committee in reasonably broad detail the audit work done, the assumptions made, their views as to the adequacy of internal controls, their opinion as to loss provisioning and any other observations which they wish to make.

The Audit Committee of the Canadian Imperial Bank of Commerce also plays a key role in its affairs. Its meetings are frequent and deal with many details so that it actively examines the financial condition of the bank. In recent years, the Audit Committee met at least once a month and examined the loss provisions made for every significant account. Accounts are also reviewed by industry sector. There is a minimum requirement of four meetings per year.

In general the role of the Audit Committee at the Royal Bank is to ensure to the extent that it can that the auditing processes within the bank, both by the internal audit and the external audit, meet the criteria that a prudent director would normally expect. The Committee's written terms of reference direct it to meet from time to time with the internal and external auditors to discuss the scope of the annual and interim examinations made by the auditors and to review the controls, procedures and accounting practices of the bank. The Committee also reviews the audited financial statements, prospectuses, management plans for information systems, and recommendations with respect to the nomination and remuneration of auditors.

Generally speaking, audit committees do not get involved in individual loans. It is not within the terms of reference of the audit committee of any of the banks which appeared before this Inquiry (including CCB and Northland Bank) to consider loss provisions on individual loans (other than large and significant loans) or to consider whether a loan should be classified as unsatisfactory or given any particular status for the purpose of income recognition. However, the adequacy of the total level of loss reserves is assessed by the audit committee.

The work of the audit committee in all the major Canadian banks is closely related to the work of the external auditors who play an integral role in identifying any problems which the bank may have.

C. EXTERNAL AUDITORS

Since 1923 the *Bank Act* has required the engagement of two firms of accountants to serve as shareholders' auditors in a bank. By s.242 the primary duty of the auditors is to examine the annual financial statements prepared by management and to report to the shareholders as to whether such statements (which shall include the statement of assets and liabilities, the statement of income, the statement of appropriations for contingencies and the statement of changes in shareholders' equity) reflect fairly the financial position of the bank at the end of the financial year in question and the results of operations for the year under review. Where the examination has not been made in accordance with generally accepted accounting principles (GAAP) or was not prepared on a basis consistent with the prior year, the auditors are required to include such remarks as they consider necessary. The *Bank Act* further provides that:

> It is the duty of the auditors of a bank to report in writing, individually or jointly as they see fit, to the chief executive officer and chief general manager any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification, and without restricting the generality of the foregoing, they shall as occasion requires make a report to those officers with respect to
>
> (a) transactions of the bank that have come under their notice that, in their opinion, have not been within the powers of the bank, and
>
> (b) loans owing to the bank by any person the aggregate amount of which exceeds one-half of one per cent of the total of the paid-in capital, contributed surplus and retained earnings accounts of the bank, in respect of which, in their opinion, loss to the bank is likely to occur....

Such a report shall also be presented to the board of directors and to the Inspector General.

The reporting format for the annual financial statements to shareholders is prescribed by the *Bank Act*. The components of the financial statements are to be prepared in forms specified by particular schedules to the *Bank Act*. The accounting principles for banks prescribed by the *Bank Act* and by regulations from the Office of the Inspector General of Banks (OIGB) are different from generally accepted accounting principles, with which users of financial statements can be expected to have some basic familiarity. In Canada, GAAP have been prepared and are regularly modified by the Canadian Institute of Chartered Accountants. Some provisions of the *Bank Act* modify the application of GAAP to bank auditing. Other provisions of the *Bank Act* create additional accounting rules.

The statement of appropriations for contingencies is the most significant departure of bank accounting practices from generally accepted accounting principles. The appropriations for contingencies account is included in the "Capital and Reserves" section of a bank's balance sheet. Once a bank's actual loan loss experience for the year is known, the provision for loan losses is determined by calculating the ratio of the total loan loss experience to the total eligible loans outstanding for the current and four preceeding years, and applying this ratio to loans at the end of the current year. This figure is credited to appropriations for contingencies and charged to the income statement. The actual loan loss experience for the year is charged to the appropriations for contingencies account. This procedure has the effect of smoothing the annual charge to income for loan loss expense. Other entries to the appropriations account are transfers to and from the retained earnings account.

A typical certificate issued by bank auditors reads:

> Auditors' Report
> To the Shareholders, The Royal Bank of Canada
>
> We have examined the consolidated statement of assets and liabilities of the Royal Bank of Canada as at October 31, 1985 and the consolidated statements of income, appropriations for contingencies and changes in shareholders' equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.
>
> In our opinion these consolidated financial statements present fairly the financial position of the Bank as at October 31, 1985 and the results of its operations for the year then ended in accordance with accounting principles

prescribed by the Bank Act applied on a basis consistent with that of the preceding year.

Touche Ross & Co.
Price Waterhouse
Chartered Accountants

Montreal, December 2, 1985

The Canadian Institute of Chartered Accountants is the professional body primarily responsible for establishing standards for the accounting and auditing profession in Canada. In the handbook published by the CICA for the guidance of its national membership, the certificate to be issued by auditors in approving financial statements generally reads as follows:

AUDITORS REPORT

. . . . .

In my opinion, these financial statements present fairly the financial position of the company as at ________, 19__ and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

City (signed)________________________
Date CHARTERED ACCOUNTANT

The Minister may under s.242 of the *Bank Act* require that the auditors report on the adequacy of bank control procedures, and the Minister may enlarge or extend the scope of an audit or direct any other or particular examination to be made, at the bank's expense. Such a review has never been directed, yet the existence of the power to so order distinguishes audit provisions in the *Bank Act* from other statutes dealing with corporate auditors and emphasizes the public interest in the well-being of the banking industry.

The work of bank auditors is of particular importance to the OIGB, the principal government agency in the field of bank supervision. Access by the OIGB to the work of the auditors comes about in three ways: (i) the OIGB may under s.246(5) contact a bank's auditors to obtain clarification on matters coming to its attention and concern; (ii) the OIGB meets with the auditors during the annual inspection of each bank to discuss accounting policies of the bank and bank procedures; and (iii) the OIGB relies on the financial statements as certified by the auditors.

There is some imprecision in the present *Bank Act* in establishing either the right of the Inspector General to consult with and to obtain information from the auditors, or the right of the auditors to communicate their concerns and advice to the Inspector General without breach of their statutory or professional duty. On the other hand, the OIGB relies on the auditors in the great bulk of its work in the credit evaluation area, that is, in assessing the value of the loan portfolio of a bank. Whether specific loan provisions are adequate, capitalizing of interest is justified, and accrual and recognition of fee and interest income is appropriate, are matters left to the auditors. Additionally, although the OIGB will review the stated policies of the banks and on occasion issue guidelines, it is left to the auditors to ensure that stated policies are adhered to and that the control systems within the bank are effective and applied.

On the other hand, the auditors do not give an opinion specifically directed to these matters. Section 5000.01 of the CICA Handbook explains in relation to the standard opinion language that: "... such an opinion is not an assurance as to the future viability of an enterprise nor an opinion as to the efficiency or effectiveness with which its operations, including internal control, have been conducted." The auditors state that their function is to seek reasonable assurance that the financial statements taken as a whole are not materially misstated. Further, audit procedures are designed on the assumption of management's good faith, subject to the exercise of the auditor's professional judgment as supported by examination and outside assistance as required.

In practice, the determination of whether there has been compliance with bank procedures is generally left to the internal inspection function of the bank. The auditors participate in the planning of the internal inspection department inspections and assess the adequacy and quality of the inspection department in order to assess the results of the internal inspection. This sequence in turn leads the auditors to their decision whether to rely on the inspection department. In the Northland Bank the auditors did not initially rely on the internal inspection department at all, and never developed the state of reliance and cooperation seen in the major banks.

In the credit area, auditors have recognized that they are not bankers. Therefore, the taking of provisions for anticipated losses and the propriety of the capitalization of interest and of the accrual of interest are the preserve of management. The auditors' role here is to assess the reasonableness of management's judgment. The auditors do not review all loans in the bank; nor do they necessarily review all the actual loan files. The review of loans selected by the auditors may not go beyond an examination of board sheets or loan summaries prepared by bank management. Of course, auditors do exercise independent judgment. For example, one experienced bank auditor testified:

> When an auditor reviews any doubtful loans to which management has already made a judgment, it is my view that the auditor must be prepared, based on his own judgment, and within the context of his overall view of the loan provisioning in that organization, to disagree with the judgment of management and to consider the need for a qualification of accounts if an increase in the specific provision that he feels is necessary is not made and it is material.

It is clear that the Inspector General, in discharging his duty under the *Bank Act* to examine and inquire into the business and affairs of each bank, relies heavily upon the external auditors of the bank for financial information relating to the bank's operations and particularly relating to the state of the loan portfolio. The external auditors in turn rely upon the management of the bank who prepare and present in the first instance the financial statements for the period from time to time being reported upon. The external auditors also rely, in varying degrees according to their discretion, on the internal audit or inspection system of the bank. The internal inspection system, with some very few exceptions, in turn looks to management for assessment of loan loss provisions, valuation of loans and related matters. Thus it can be said that the inspection system is founded upon information presented by the management of the bank which drifts upwards through inspection and audits until it reaches the Inspector General in the course of his supervisory function.

Where auditors do have concerns about bank practices, it is expected that they will express them to the Inspector General. This occurs in the course of the annual inspection of each bank. Further, the auditors' Memorandum for Discussion with the audit committee (if any) is available for review by the Inspector General. It is a part of the Inspector General's inspection to review the minutes of the board meetings and of the audit committee meetings. It has not been the practice of the Inspector General to meet with the audit committee of the board of directors.

In the course of the Inquiry, various parties were asked for an opinion why the *Bank Act* provides for dual auditors. Although each firm takes overall responsibility for the audit, the workload is allocated between the two firms. Auditors believe that the dual audit system ensures that conflicts of interest can be accommodated; that is, where a borrower is a client of one auditor, the other auditor is available to review the loan file. They also believe it promotes the independence of the auditors because the auditors, when challenging the financial statements prepared by management, speak with two independent voices. The developing practice in the banks is to retain a lead auditor on a continuous basis and alternate the second auditor on a two-year roll-over basis. This is consistent with the *Bank Act* and, according to the evidence, has been adopted to produce considerable efficiencies and savings in expense and management time. However, the practice does weaken, somewhat, the argument that independence of the auditors is reinforced by the dual system.

D. INSPECTOR GENERAL OF BANKS

1. Responsibilities of the OIGB

The primary responsibility of the Office of the Inspector General of Banks is set out in s.246 of the *Bank Act*: the Inspector General is responsible to the Minister of Finance generally for the administration of the Act and has the status of a deputy minister. He is obliged by the statute to inquire into the affairs of each bank at least annually so as to satisfy himself that the provisions of the Act regarding the safety of the interests of depositors, creditors, and shareholders are observed, that other provisions of the Act are observed, and that the bank is in a sound financial condition. The Inspector General reports in writing to the Minister at the conclusion of each annual examination.

2. Organization and Staffing of the OIGB

The Inspector General is an officer of the Department of Finance appointed by the Governor in Council on the recommendation of the Minister in whose opinion the nominee "has had proper training and experience to be the Inspector General of Banks". At the time here in question the Inspector General was a career public servant with experience in the Department of Trade and Commerce and the Department of Finance, as well as a period on secondment to the Royal Commission on Banking and Finance.

The personnel of the OIGB are members of the Public Service of Canada and, as such, their employment and remuneration are governed by the regulations applicable to the civil service generally. However, the cost of operations of the Inspector General's office is borne by the banks chartered under the *Bank Act* by an annual assessment based on their individual average total assets. At 31 March 1984, the last fiscal year end of the OIGB prior to the implementation of the CCB Support Program, the actual strength of the office was 29 persons, including 14 classified as inspectors, analysts or equivalent. These officials were responsible, at that time, for the supervision of some 70 banks. Table 3.2 presents information on the size of the OIGB for the period 31 March 1977 to 31 March 1986.

Table 3.2

OIGB STRENGTH 1977 – 1986

As at March 31	*Actual Strength*	*Analyst/Inspector/ Equivalent*
1977	7	N/A
1978	13	6
1979	16	8
1980	18	8
1981	20	11
1982	19	9
1983	28	12
1984	29	14
1985	35	17
1986	48	21

For about half a century, from 1925 to the mid-1970s, there were never more than eleven banks licensed to operate in Canada. Some new Schedule A banks, including the CCB and Northland, came into operation in the mid-1970s. Shortly after the 1980 *Bank Act* revision, 60 Schedule B banks were introduced into the banking system. As Table 3.2 indicates, no significant increase in the inspection staff of the OIGB occurred. Only six inspectors were added between 1981 and 1985.

Staff size is of some importance in relation to the matters before this Inquiry for the Inspector General has in the past requested and has been denied by the government increases in staff as the responsibilities of the OIGB expanded. For example, on 11 May 1982, in an appearance before the House of Commons Standing Committee on Finance, Trade and Economic Affairs, the Inspector General said:

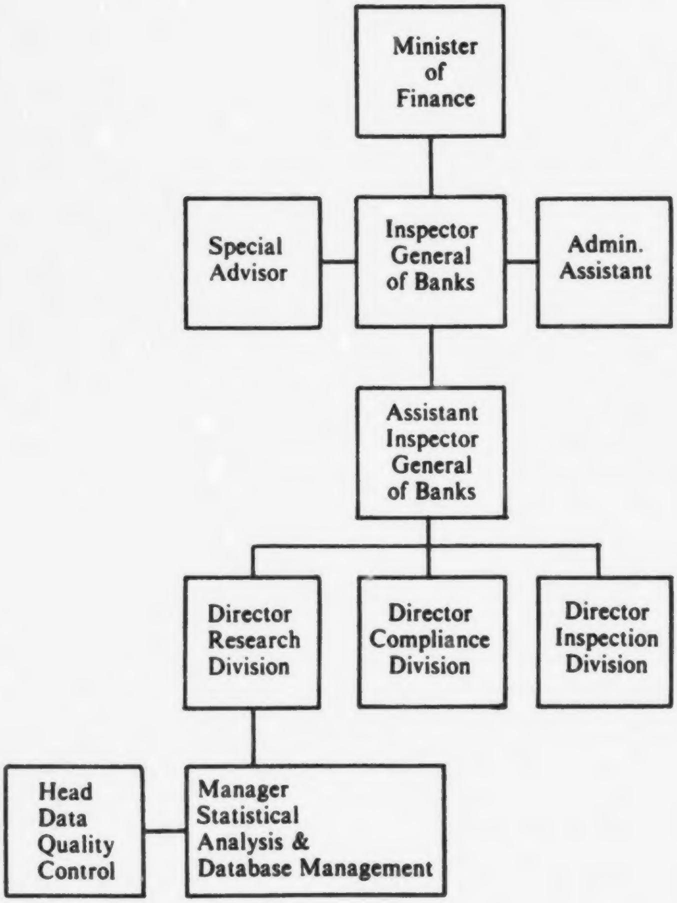
> The staff is too small. It is too small in the structure of the responsibilities we have been given under the new *Banks and Banking Law Revision Act* of 1980; in terms of an enormous increase in the compliance responsibility under the legislation; in response to the chartering of the number of new banks; and in terms of the monitoring of this rapidly expanding and complex system.

On the same occasion the Inspector General did express the view that the existing staff was sufficient to "monitor adequately the general health of the banks and of the system", although it would be "extremely difficult" to do so.

The OIGB is organized in three divisions corresponding to the principal functions of the office: research, compliance and inspection.

Table 3.3

ORGANIZATION CHART
OFFICE OF THE INSPECTOR GENERAL OF BANKS
1 April 1985


Minister of Finance
Special Advisor
Inspector General of Banks
Admin. Assistant
Assistant Inspector General of Banks
Director Research Division
Director Compliance Division
Director Inspection Division
Head Data Quality Control
Manager Statistical Analysis & Database Management

a. Research Division

The Research Division has five principal functions: general research and analysis, prudential policy development, tax and accounting policy development, statistical analysis and data base management, and the early detection of problem banks. The Research Division analyses the returns required of the banks, and is also responsible for the maintenance of an "early warning system", which is intended to identify those banks requiring special attention because of emerging problems and to detect unsatisfactory trends in the industry.

b. Compliance Division

This Division, as the name suggests, performs an enforcement role. Specifically, the Compliance Division must ensure that banks and others are complying with banking legislation and related regulations by developing and enforcing appropriate standards, policies and procedures. The Division will recommend and carry out the imposition of approved directives to the banks and direct the taking of legal proceedings, if necessary, in cases of noncompliance. The Division maintains contact with senior officers of banks, legal counsel, accounting firms, officials of federal and provincial government departments and private sector sources in order to ensure awareness of developments related to banks, individually or collectively.

c. Inspection Division

This Division plans, organizes and directs a program of continuous examination of the financial position and operating results of all the Schedule A and Schedule B banks pursuant to the *Bank Act*. The inspection provides the basis for the Inspector General's annual report to the Minister of Finance on the financial condition of each bank.

To carry out its work, the Inspection Division is required to develop standards, policies and practices for the conduct of examinations of all the banks. The Division may recommend, as required, the imposition of constraints on the activities of a bank or banks where inspections indicate that such action is necessary in the interest of depositors or shareholders.

3. Regulatory Procedures

The banking industry is regulated in four ways: statutory restrictions, regulations promulgated by Order in Council, ministerial regulations and directives, and guidelines issued by the Office of the Inspector General.

The *Bank Act* itself places statutory restrictions on the nature of the business that a bank may undertake. Apart from the duty of care placed on the directors of a bank, the Act does not regulate the manner in which business is conducted (that is, whether business decisions are prudent or imprudent). Banks are required by s.175 of the *Bank Act* to maintain adequate capital and liquidity, and the Minister of Finance may issue directives in relation to these matters. The effectiveness of such a directive, of course, depends upon the availability to the bank of such capital as may be directed and this will depend upon market availability or, in the case of a Schedule B bank which is a subsidiary, the strength of the parent organization.

The regulations deal with a variety of matters, including Banking Related Data Processing Services, Cost of Borrowing Disclosure, Financial Corporations, Guarantees, Insider Reports, Prospectus Requirements, and Venture Capital Corporations. The only regulations dealing with solvency and liquidity are the Reserves Regulations, promulgated by Order in Council pursuant to s.208 of the *Bank Act*. These regulations prescribe the primary and secondary reserves which a bank is required to maintain and the method of their calculation. These reserves are classified by the regulations either as primary reserves, which are interest free cash deposits with the Bank of Canada, or secondary reserves to be held by the bank itself in the form of, *inter alia*, treasury bills and day loans to investment dealers.

Guidelines of the OIGB fall into two classes: rules regarding the completion of statistical returns to the OIGB, and rules regarding the standardization of certain banking procedures. Most guidelines apply equally to all banks. Although the guidelines have no legal force, the banks have historically cooperated with the OIGB by complying with them on a voluntary basis. Some of the more important guidelines are discussed below.

a. Capital and Leverage

Capital adequacy and leverage, both of which terms describe the relation between the capital of a bank and its assets, are the subject of OIGB guidelines for Schedule A banks. These guidelines provide a definition of capital for regulatory purposes. They are relatively new, having been issued on 3 March 1983, amended on 19 December 1984, revised on 15 February 1985, and further clarified in a letter of 21 June 1985. The maximum leverage ratio considered appropriate by the OIGB is between 20 and 25; that is, a bank may have 20 to 25 times as many assets (principally outstanding loans) as capital. Capital adequacy standards are implemented on a bank-by-bank basis in the course of the discussions which take place at the time of each bank's annual inspection.

b. Prudential Lending Limits

There are also guidelines on prudential lending limits. The maximum exposure to individual or related borrowers is limited in relation to the capital of the bank. In 1983, Schedule A banks were limited to 50 per cent of capital for single or connected loans. Schedule B banks were allowed to go to 100 per cent in order to permit earlier attainment of profitability. More recent guidelines have developed a plan for varying the rule according to the circumstances of the bank. For example, the Northland Bank limit was 25 per cent subject to increase to 50 per cent in special circumstances.

The Inspector General also issues directions or suggestions to individual banks, usually after the annual inspection. For example, the Inspector General instructed Northland to limit the expansion of its loan portfolio in 1984-85. This direction or suggestion was disregarded, or more accurately defied, by the bank. The Inspector General's response was limited to proposing that a meeting be held with bank officers.

c. Nonperforming Loans

There is a guideline respecting disclosure of nonperforming loans. The *Bank Act* requires a statutory return of noncurrent loans, as defined in s.58(2) of the *Bank Act*, to the Minister. A noncurrent loan is one where no payment is received by the bank from the borrower, using the borrower's own funds, for periods specified in the statutory definition. The Inspector General has in the past recommended legislation strengthening this definition, without success.

The OIGB has recognized that other statistics regarding loans are useful in measuring the health of the bank. Hence, since 1982, banks have been required to report (in addition to the statutory report on noncurrent loans) unsatisfactory loans on a quarterly basis. In the past, it has been left open to banks to define an unsatisfactory loan, and such loans have been described and reported under various names and definitions by the several banks. As a result, there was some confusion as to whether the figures coming from the banks were comparable. In a statement on nonperforming loans in June 1984, the OIGB introduced a standardized definition of nonperforming loans, and prescribed the treatment of the recognition of income on such loans. All banks were required to follow the guideline set out in the paper for the 1985 fiscal year. This guideline offers a definition of a nonperforming loan, but leaves a discretion in the bank to determine whether a specific loan does or does not fall within the class. More details about this guideline are found in Appendix F.

d. Sovereign Loans

Many banks have engaged in lending to foreign governments. These loans are referred to as sovereign or country loans. Sovereign loans have been treated both by the Inspector General and by the banks as being quite different from domestic loans, and are subject to different accounting applications for the determination of reserves and other matters in connection with reporting these loans in financial statements of the banks. The OIGB has recently been involved in offering guidance to the banks regarding loss provisions on sovereign loans as a class (and not on an individual loan basis) and the accounting treatment of such provisions in the bank's financial statements. There is no similar guideline in relation to domestic loans since it is felt by the Inspector General that such a guideline may tend to become a substitute for the judgment of senior management.

Sovereign lending was never a significant activity in CCB. A large percentage of Northland's early loans were made to foreign countries, but the proportion of such loans diminished after 1979, and by 1985, represented only $37.5M of the $1.2B loan portfolio.

4. The Bank Inspection Process

Bank inspection is a two-stage process. First, banks submit responses to a pre-inspection questionnaire. This questionnaire, in the case of domestic banks, is tailored to each bank, and will cover individual loans, bank organization, off balance sheet liabilities, dealing in foreign exchange markets, and any other matter of concern to the inspectors. On the basis of the questionnaire and information already available to it, the OIGB produces a pre-inspection report. This document provides a guide or agenda to the inspectors for the consideration of the various concerns the OIGB may have in relation to a particular bank. The inspectors are now concerned principally with capital adequacy, asset quality, management quality, earnings, and liquidity. This review system is sometimes referred to as CAMEL.

Through 1982 and 1983, the reported data were analyzed within the OIGB on a semi-mechanical or manual basis. The analysis was focused on the annual inspection and formed the basis of the pre-inspection reports prepared in advance of the on-site examinations of banks. The analyses employed many of the same ratios which are part of the Early Warning System, and underlay the conclusions and judgments reached concerning the condition of the bank under review. Due to the fact that much of the data analysis was done manually, it was not feasible at that time to make comparisons at as many points in time as is possible in a electronic system. A revised mechanized Early Warning System supplanted the manual methods during 1984. The ratios produced by this system are based on the same data submitted during 1982 and 1983 which were used in the manual analysis. The complete conversion of the analysis of data in the OIGB and the Early Warning Systems, to an electronic basis, has now been completed.

Following completion of the pre-inspection analysis, two or three inspectors (depending on the size and nature of the bank) undertake an on-site inspection at the head office of the bank. The inspection lasts between one and four days, and consists of discussions with senior officers of the bank, with the heads of various divisions of the bank, and with the external auditors. The inspectors also review minutes of the board of directors' meetings to ensure that management is providing the directors with the information necessary for them to fulfill their responsibilities. In the case of domestic banks it is customary for the Inspector General or the Assistant Inspector General to join the inspectors prior to the completion of the on-site investigation.

A Post-Inspection Report is then prepared, and the appropriate opinion is sent to the Minister. The Post-Inspection Report has been considered by the OIGB to be an internal document, and unavailable to the auditors, to bank management, or to the directors. At the time of the Inquiry, this policy was under review by the OIGB. Beginning with inspection reports prepared in 1984, the Inspector General rates each bank on a numerical scale on the basis of its inspection.

In the course of the year, any concerns which the inspectors may have, will be dealt with by communication with the various banks, as required. Such communication may also relate to information obtained through an informal network, including foreign regulators and other government departments, or through scrutiny of the returns provided to the OIGB by the banks periodically throughout the year.

The main character of the inspection system, according to the OIGB, is reliance on the two external auditors of each bank. The efficiency of, and compliance with, internal control systems of each bank is left to the internal and external auditors for evaluation. The OIGB does not test internal control systems of banks, compliance with stated policies, or the value and regularity of the loan portfolio (at least until 1985). The OIGB acquires piecemeal evidence of various practices going on in the banks, but the office does not have the resources to examine the component loans in the entire portfolio. The acceptance of financial statements as reported on by the auditors is a fundamental part of the inspection process, and the notes to the financial statements are relied upon to determine what policies govern the business of the bank.

As a result of the CCB experience of March 1985, the OIGB has decided to engage retired bankers to conduct inspections of the component loans in the loan portfolio. As of January 1986, the OIGB employed seven retired bankers under contract, and had engaged by secondment one active banker from the staff of a Schedule A bank whose function is to train inspectors rather than to inspect on-site himself. This team has been to a few of the banks, and is expected to visit every bank. Whether this is to be done annually in all banks has not yet been determined. The OIGB also plans to commence review of the auditors' working papers.

5. Reliance and Accountability in Canadian Bank Supervision

The Canadian system of bank supervision rests upon the separate performance by management and the directors, the external auditors, and the OIGB of their respective duties, and upon the relationship and interaction between them. These interrelationships, and in particular the extent to which any party may reasonably have relied on the conduct of the others to support or sanction its own judgment on various matters of concern to the safety and soundness of a bank, have been particularly controversial throughout the Inquiry. The importance of suitable means to ensure accountability and the need to adapt those means to an efficient supervisory system will be central to the recommendations set out in Chapter 6. Here it is sufficient to illustrate the divergence of views put forward at the Inquiry by reference to the submissions of counsel for several of the participants on this basic issue.

Counsel for the OIGB stated in final argument:

> In assessing both the system and the conduct of those responsible for its implementation, it is important that we put this whole problem in the context in which the system was understood. For a number of years in this country, up until recently, it was assumed by the public and Government of Canada, that the Inspector General of Banks could and should rely on audited financial

> statements and financial data reviewed by auditors, and it was assumed and understood that the Inspector General did not have adequate resources and personnel to perform independent analysis to show that that reliance was justified. And so, in my submission, it was no part of the responsibility of Mr. Kennett or other members of the office to second-guess the basic structure that was in place for them.

Counsel for the CCB auditors stated:

> However, it is submitted that to characterize the auditors as the pivotal point or cornerstone of the system, or to say that the main character of the bank regulatory system in Canada is its reliance on the two external auditors, overstates the role of the auditors as part of the regulatory system, (as opposed to their function as auditors for the bank and its shareholders) and understates the role of the Inspector General of Banks. It is the Inspector General who has the ongoing duty to review the financial condition of banks, the full power to review all of the records and activities of a bank at any time and to take steps to enforce the provisions of the Bank Act as required.

Counsel for the Northland Bank auditors stated:

> We submit that the auditors' responsibility is limited by law and practice to an opinion on whether the financial statements of Northland Bank present fairly the financial position and operating results of the bank in accordance with prescribed accounting principles. Absent specific additional responsibilities under the provisions of the Bank Act, or as agreed with management, the auditors had no other responsibilities or obligations.

Counsel for the Bank of Nova Scotia and the Canadian Imperial Bank of Commerce stated:

> A basic thrust of this submission is that these failures occurred largely because the two banks in question departed from the practices which have made the Canadian banking system stable and successful over such a long period by assuming excessive risks and that the system of governance employed by them was defective. It will also be submitted that the experience of these banks and the regulatory systems of other countries shows that there is no magic formula which will minimize the risk of failure. Rather it will be submitted that the stability of the system must depend largely on establishing a form of corporate governance which will lead to prudent management supplemented by a regulatory scheme designed to ensure that early remedial action is taken when this is not present. It will be submitted that the evidence demonstrates that the beneficial effect of regulation is limited as ultimately the safety of the system must depend on the management and the directors of banks.

Counsel for the Directors of the CCB stated:

> Of all those with responsibilities concerning the financial information of the bank (the board, the auditors, management and the OIGB) only the board of directors has no hands-on role in performing or inspecting the valuation, accounting and other processes which culminate in the preparation of the financial statements. The board must rely on its officers, employees, auditors, lawyers, regulators and other professionals who prepare and explain the

> reports tabled before them. In deciding to approve the financial statements, directors must discharge their duties to act reasonably, in good faith and with a view to the best interest of the bank, but in doing so are expected and entitled to rely on information and opinions provided to them by others.

Before turning to the analysis of events surrounding the cessation of operation of the CCB and Northland, several other agencies or institutions require brief descriptions.

E. THE DEPARTMENT OF FINANCE

The *Bank Act* vests in the Minister of Finance certain powers including the power to revoke the appointment of auditors (s.239(1)), to require auditors to report on the adequacy of procedures adopted by banks for the safety of creditors (s.242(1)), to enlarge the scope of the audit (s.242(2)), to dispense with the audit committee of the board of directors (s.243(2)), to require a bank to furnish "such other information at such times and in such form as the Minister may require" (s.229), and to authorize an examination or inquiry when it is believed that an offence under the *Bank Act* has been committed (s.246(4)). The Minister also has authority to issue written directives to a bank in relation to capital adequacy and liquidity (s.175(1)). The Minister is required to appoint a curator to supervise the business and affairs of a bank which suspends payments in Bank of Canada notes of any of its liabilities as they accrue (s.278(1)) and may make such an appointment if the Inspector General reports the opinion that a bank will not be able to pay its liabilities as they accrue (s.278(2)). All such powers are exercised on the basis of factual evidence, or reasonable cause for concern.

The Minister of Finance, in the present Government, delegated his responsibilities for the administration of the *Bank Act* to the Minister of State (Finance). By letter dated 5 October 1984, the Minister of Finance authorized the Minister of State (Finance):

> Subject to such directions and guidelines as I may give you from time to time to exercise the powers, duties and functions of the Minister of Finance under the statutes administered under my direction by the Department of Insurance and the Inspector General of Banks.

All parties before the Commission assumed that there are no legal impediments to such delegation. In practice, delegation has often entailed joint action under the *Bank Act* by the two Ministers while, as the Minister of State (Finance) explained, "the ultimate responsibility remains with the Minister of Finance."

The Deputy Minister of Finance serves as the administrative head of the department. The OIGB is a branch of the Department of Finance and the Inspector General has the status of a Deputy Minister with a statutory reporting accountability to the Minister of Finance. In practice the Inspector General reports to the Minister of State (Finance).

The Minister of State (Finance) relies heavily, as to bank matters, on the Inspector General who has extensive contact with other officials in the Department of Finance, particularly in the Financial Sector Policy Branch. In effect, the Inspector General runs the day-to-day business of administering the *Bank Act* and the Minister's attention is ordinarily restricted to policy decisions. In making such policy decisions, the Minister derives assistance from the Inspector General, from the Capital Markets Division of the Department of Finance, and from personal staff, although members of these two latter groups do not, at least at present, have banking backgrounds.

Both Ministers testified that the Inspector General is intended to have a measure of independence from the Ministry to insulate him from purely political considerations. This flows from the fact that the Inspector General holds office during "good behaviour". The independence is intended to enhance the quality and objectivity of the advice on which the Ministers rely.

F. THE BANK OF CANADA

The Bank of Canada undertakes a number of distinct tasks as the nation's central bank. One of these tasks is to act as the fiscal agent for the Government of Canada. In this role, it advises on and manages the national debt. The Bank of Canada also advises on exchange market matters, manages the country's international reserves and buys and sells foreign exchange in accordance with the Government's policy regarding intervention in the exchange market.

In its other roles, the Bank of Canada acts as principal. The Bank of Canada's primary function is formulating and implementing monetary policy. The Bank of Canada also acts as banker to the nation's banking system, and serves as a source of liquidity support under certain conditions.

There are essentially two types of situations which call for liquidity support from the Bank of Canada. The first pertains to temporary advances, generally for a term of one day, which the Bank of Canada is prepared to provide, within certain limits, to chartered banks encountering shortfalls in their reserve balances as a result of unexpected payment flows associated with the daily cheque-clearing and settlement process. In addition, banks are required to maintain reserves at the Bank of Canada in accordance with s.208 of the *Bank Act*, and advances are at times required by the banks to meet these reserve requirements. Loans in this first category are sometimes referred to as ordinary advances.

The second situation concerns requests for extraordinary advances. In making extraordinary advances, the Bank of Canada provides special assistance to chartered banks which are experiencing difficult liquidity problems because of a loss of depositor confidence and are unable to meet deposit withdrawals from their own resources (for example, by selling liquid assets) or from additional deposits raised in the market at or near their usual rates of interest. The *Bank of Canada Act* (s.18(1)(h)) allows the Bank of Canada to make loans or advances for periods not exceeding six months. Such loans or advances may be renewed. Extraordinary advances are intended to prevent the failure of the particular institution which is illiquid but still solvent, and to preserve confidence in other deposit-taking institutions and the financial system.

The Bank of Canada is required by s.25 of the *Bank of Canada Act* to transmit weekly and monthly to the Minister of Finance a statement of assets and liabilities in a form which stipulates the reporting of advances to provincial governments and to "Members of Canadian Payments Association" which includes all banks. This information is published by the Government of Canada in the *Canada Gazette*. In this way, liquidity advances to members of the Canadian Payments Association are disclosed on an aggregated basis. Pursuant to s.232 of the *Bank Act*, information on individual banks contained in certain returns required from the banks, including Schedule J of the *Bank Act*, within which advances to a bank from the Bank of Canada are specifically set out, is published monthly in the *Canada Gazette*.

Accumulating the knowledge to assess the financial soundness and solvency of chartered banks is an integral part of the process of bank supervision. The Bank of Canada does not have the powers to undertake prudential supervision of banks; it does not have the power to demand information on a regular basis on the individual loan or deposit transactions of banks. As a result, the Bank of Canada has no bank auditors, no bank examiners and no personnel experienced in the inspection or supervision of chartered banks. The Canadian system of bank regulation and supervision, based on an information network of external bank auditors, internal bank inspection systems and bank managements, operates in conjunction with the Inspector General of Banks. The Bank of Canada's contact with the supervisory system is through the Inspector General of Banks. The system is designed to operate separately from the Bank of Canada, and the central bank must rely on the judgments that emerge from it. If according to these judgments a bank is solvent, then the Bank of Canada stands prepared to provide any liquidity support required although it naturally expects the borrowing bank to take action, as soon as possible, to reduce its reliance on Bank of Canada advances. Neither the *Bank of Canada Act* nor the *Bank Act* specifies this policy in precise terms, but the Bank of Canada and the OIGB together adopted a practice in connection with these two banks whereby the Inspector General determined that the bank was not viable and would be insolvent in the absence of Bank of Canada liquidity advances, and in reliance thereon, the Bank of Canada then ceased to make liquidity advances.

It should be noted that the Bank of Canada and the OIGB maintain close and constant contact on an informal basis. The two offices share certain statistical data. The Bank of Canada makes available to the OIGB all qualitative and statistical information that it receives concerning individual banks. In addition, the Bank of Canada processes a number of statistical returns required by the OIGB pursuant to the *Bank Act*. However, the Bank of Canada does not process or receive returns showing information on individual loan and deposit accounts or any other prudential information pertaining to the operations of chartered banks. The Inspector General will naturally make available to the Bank of Canada his solvency judgments based upon the results of inspections conducted by or on behalf of the OIGB.

In recent years, the Bank of Canada has, on occasion, facilitated the arrangement of special lines of credit amongst Canadian chartered banks. Such lines of credit provide an indication of confidence in the bank that is provided with the special line of credit. In addition, it produces less publicity if a chartered bank arranges a special line of credit with other chartered banks rather than receiving advances from the Bank of Canada.

The role of the Bank of Canada in events surrounding insolvency, real or apprehended, in a bank is examined further in Chapter 6.

G. THE CANADA DEPOSIT INSURANCE CORPORATION

The Canada Deposit Insurance Corporation (CDIC) is a corporation created under the provisions of the *Canada Deposit Insurance*

Corporation Act, (*CDIC Act*) for the purpose, among others, of providing deposit insurance with respect to insured deposits with member institutions. Generally speaking, the CDIC insures deposits up to $60,000. However, because various types of accounts or deposits may constitute separate "deposits" for the purpose of deposit insurance, an individual may have insured deposits in excess of $60,000. The CDIC was also intended to provide emergency liquidity funding to deposit-taking institutions and to assist in improving the regulation of such institutions. This authority was not invoked in connection with either of these two banks.

The Chairman of the CDIC is appointed by the Governor in Council on the recommendation of the Minister of Finance of "a person of proven financial ability". The CDIC Board of Directors includes the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Insurance and the Inspector General of Banks or designated alternates, and the Chairman of the CDIC. Recent amendments to the *CDIC Act* provide for up to four additional members appointed from outside the public service.

While the CDIC is, for all purposes, an agent of the Crown in right of Canada and has the ability to borrow from the Government of Canada to meet current obligations, its ultimate source of funds is premiums from member institutions (virtually all of the federally-incorporated deposit-taking institutions and many provincially-incorporated deposit-taking institutions) together with their respective depositors. Thus, deposits made with them, to the appropriate limits, are insured by the CDIC. Premiums, formerly charged at the rate of one-thirtieth of one per cent of insured deposits, have recently been increased to one-tenth of one per cent.

The CDIC's rarely used power to make loans to member institutions for the purpose of reducing or averting a threatened loss to the Corporation is found in s.11(a) of the *CDIC Act*. The advances can be made where an institution requires liquidity support to avoid forced liquidation of assets. In some cases, advances were made where an institution had been closed and the Corporation was faced with paying the insured claims. In such a case, funds can be advanced after the institution has been closed to enable liabilities to be met as they come due. This approach (known as the "run-off" method) is taken where it is thought the cost to the CDIC would be less than putting the institution under formal liquidation and paying all the insured depositors at one stroke and also paying liquidation costs. This method can sometimes benefit uninsured depositors as well as insured depositors.

While the CDIC has the responsibility to insure deposits and to compensate depositors for the loss of their insured deposits in failed member institutions, it has only limited powers to prevent failures (particularly in the case of chartered banks) or to attempt to avoid future problems through inspection procedures or by regulation. Under s.21(1) of its Act, the CDIC is entitled to have the affairs of each Canadian chartered bank examined on its behalf by the Inspector General of Banks at such time as the Corporation may require, but at least once each year. The CDIC is not otherwise empowered to conduct any examination of a bank.

The CDIC is also entitled to "prescribe standards of sound business and financial practices" for member institutions and when it holds the view that a member institution is following unsound business or financial practices, the Corporation is required by s.24 of its Act to report the facts in writing to the president or chairman of the member institution. There is no clear guidance in the *CDIC Act* as to how such bank practices are to be discovered by CDIC. Nor is there any procedure for the issuance and enforcement of any corrective orders. For banks, at least, there is no other CDIC "regulatory" capability until a bank becomes insolvent or ceases to take deposits, in which case its insurance may be cancelled under s.27 of the Act.

For provincial institutions which are members of the CDIC the situation is different. The CDIC may select a person to inspect such an institution's affairs and may terminate (or, presumably, threaten to terminate) the deposit insurance for engaging in unsound business or financial practices, breaching a condition of the policy of insurance, or failing to remove unsound business or financial practices, or to remedy a breach of condition of the policy of insurance.

The CDIC's direct involvement in the matters before this Inquiry results from the fact that the Corporation was the insurer of many of the deposits made with the CCB and the Northland Bank. CDIC funds represented a significant component of the CCB support package in March 1985, and in the capacity of insurer the CDIC has paid several hundreds of millions of dollars to depositors in both institutions. The CDIC also commenced and successfully prosecuted the actions necessary to obtain the orders for the winding up of CCB and Northland under the *Winding-up Act* in the Courts of Queen's Bench of Alberta and Manitoba, respectively. The Corporation was appointed as Inspector under the winding-up proceedings for the CCB. The CDIC has been appointed as the agent of the Government of Canada for the purposes of the *Financial Institutions Depositors Compensation Act*, an Act proclaimed in December 1985 to provide compensation to all depositors in the two banks without the limitation applicable under the CDIC legislation. Estimates made as the compensation legislation proceeded through Parliament suggested costs to the Government of $875M, depending on the amounts to be recovered through liquidation.

H. DEPARTMENT OF INSURANCE

The Department of Insurance was established under the *Department of Insurance Act*. The Minister of Finance is the Minister responsible for the department whose Deputy Head is the Superintendent of Insurance. The latter, as noted earlier, is a member of the Board of Directors of the CDIC. The statute is not concerned with the regulation of banks and is briefly mentioned here only to facilitate understanding of matters later discussed concerning the inspection of financial institutions generally.

Where liquidity advances are made by the CDIC, the Corporation relies on the Superintendent of Insurance to examine and report on the federal trust companies and loan companies, and upon the Inspector General of Banks to examine and report on the banks. Section 251 of the *Bank Act* permits the Inspector General to disclose information to the CDIC. To examine provincial member institutions the CDIC has designated the Superintendent of Insurance. For this purpose, the Superintendent works in cooperation with provincial authorities in those provinces that have a field staff for examining provincial institutions.

From the time of its origin in the late nineteenth century, the Department of Insurance has had a field staff to examine the conditions and affairs of the institutions under supervision. The trust and loan companies came under the supervision of the Department of Insurance in 1920. The inspectors, in contrast to the Office of the Inspector General of Banks, evaluate the loan portfolio (consisting mainly of mortgage loans) of almost thirty trust and loan companies, employing for this purpose a staff of 40 or 50 inspectors in 1982. In addition, the inspectors are responsible for the examination of the affairs of between 450 and 500 insurance companies. All these examinations are undertaken by means of head office inspections carried out without prior announcement.

I. PROVINCIAL SECURITIES COMMISSIONS

Institutional arrangements regarding the regulation of bank securities and securities trading are relevant to the cessation of operations of the CCB and Northland Bank for several reasons. Each bank, in the months preceding its demise, prepared a prospectus in order to raise additional capital from public investors. The steps taken to attract new funding raise issues relating to an apparent tension in the regulation of financial institutions between depositor protection and the protection of the interests of shareholders or potential investors. Constitutional questions and practical considerations regarding interaction and communication between federal and provincial officials arise from the relationship between federal bank regulation and provincial securities regulation.

Part IV of the *Bank Act* regulates the distribution of bank securities. A bank may not distribute any of its securities unless a preliminary prospectus and a prospectus in a form substantially as prescribed by the Minister have been filed with the Inspector General. The Inspector General is under a duty to issue a receipt for a preliminary prospectus forthwith upon the filing of the document; however, where it appears to the Inspector that a preliminary prospectus in respect of which a receipt has been issued is defective in that it does not substantially comply with the requirements of the *Bank Act* and the regulations, the receipt may, under s.147, be withdrawn. The Act requires the Inspector General to issue a receipt for a prospectus filed with him unless it appears to him that the prospectus fails to comply in any substantial respect with any of the requirements of the Act or the regulations, or contains a misrepresentation or any statement, promise, estimate or forecast that is misleading, false or deceptive, or if it appears to the Inspector General that it would not be in the public interest to issue a receipt for the prospectus.

Section 148 of the *Bank Act* requires that a prospectus shall provide full, fair and plain disclosure of all material facts relating to the securities to be distributed, and shall contain such financial statements, reports or other documents as are required by regulations prescribed by the Minister under s. 146. After a receipt is issued, and before the completion of the distribution of the securities, any change relating to the distribution of these securities that could reasonably be expected to have a significant effect on the price of such securities, must be filed by way of an amendment to the proposed prospectus. Comprehensive regulations have been issued by the Minister of Finance for the approval of prospectuses under the *Bank Act*. The Act specifically covers both primary and secondary distributions of bank securities.

Provincial securities commissions are also concerned with the distribution of bank securities. For instance, both the *Ontario Securities Act* and the *Quebec Securities Act* cover any distribution of securities in those provinces, including those of chartered banks. The provincial statutes in many provinces require that there be full, true and plain disclosure in the prospectus. A preliminary prospectus must be filed. A preliminary receipt is issued for the document. Deficiency notices are given to the issuer where the provincial authority considers compliance with provincial law so requires.

In the case of a national filing, the various provincial securities commissions have agreed upon a policy of shared responsibility. The issuer selects one jurisdiction as the principal jurisdiction to act as the conduit for all communications going to and from the issuer. That jurisdiction has responsibility for the initial review of the document and for the comment deficiency letter. The other jurisdictions then have an opportunity to provide additional comments. These are collated by the principal jurisdiction, which prepares a second comment letter to be delivered to the issuer. The consolidation of all these comments in the second letter is produced by cooperation between the principal jurisdiction and the commenting jurisdictions.

Banks are not treated differently by the Ontario Securities Commission (OSC) or the Quebec Securities Commission (QSC) than any other issuer of securities except that in the course of clearing a prospectus, a copy of the comment letters is sent to the Inspector General. However, no formal procedures govern relations between the Inspector General and the provincial securities authorities. The OSC keeps the Inspector General informed of what it is doing. On the other hand, the pattern of the Inspector General's contacts with the OSC has varied over the years. For example, in 1984, the Inspector General provided copies of its correspondence with the issuer to the OSC. At other times they have not sent copies of their communications to the OSC. There appears to be no communication by the OIGB concerning the substance of specific deficiencies or other defects in prospectuses under process.

Hence, in the consideration of prospectuses, the provincial Securities Commissions and the OIGB are on separate and parallel tracks. The provincial Commission does not receive substantive information from the Inspector General to assist it in its assessment of the prospectus. The Securities Commission does not have any confidential information regarding banks. It takes the certified financial statements and the statements of the solicitors filing the document at their face value. The provincial Commission has no way of judging whether there has been a misrepresentation. Further, according to the current practice or course of dealing between the two bodies, the provincial authority is not aware of the OIGB's comments regarding prospectus deficiencies. Currently, the OIGB simply directs its requests directly to the filing solicitor. The Quebec Securities Commission asserts the right to be informed by the federal agency, the OIGB, of the inspection reports and other material, confidential and otherwise, received by the federal regulator.

The OSC is aware that the Inspector General receives confidential information through its inspection process. The Commission, therefore, takes comfort from the fact that the prospectus is approved by the Inspector General. Article 19(f) of O.S.C. Policy 5.1 provides that the OSC will not issue a final receipt in relation to a prospectus filed by a chartered bank unless the Inspector General has issued a receipt. On the other hand, the OIGB takes the position that federal bank supervisors are not responsible to attest to the accuracy of all information contained in a prospectus, but to ensure that the information called for by law or regulation is provided. The accuracy of the information is the responsibility of the issuer and, to some extent, the auditors and underwriters. Neither the OSC nor the OIGB, in most circumstances, make any qualitative or merit analysis of a prospectus. As noted above, the Inspector General may refuse a receipt for a prospectus if it is in the public interest to do so. The Ontario statute also includes some merit regulation which, according to testimony before this Commission, is only brought into play in very extreme circumstances.

The Ontario statute requires continuous disclosure of material changes. These are defined as any event that significantly affects the price of the securities in question. There is a requirement, under s.74 of the statute, to file a material change report and to issue a press release. Confidential disclosure is possible under s.74.

The conflict, real or potential, between the two levels of regulators of dealings in bank securities, is illustrated by the post-filing changes in the condition of the issuer. The Ontario Act permits the issuance of a waiver of disclosure of confidential material but such a waiver must be reconfirmed every ten days. The OSC assesses the request for confidential filing and decides whether the information may be made public. It has not been the practice of the OSC to allow a matter which ordinarily would call for disclosure to be kept in confidence on an indefinite basis; the objective is to get the information out as quickly as possible. This might raise serious concerns in the case of a bank bearing in mind its sensitivity to shifts in the level of public confidence. However, as long as the continued confidentiality can be supported, the information might never be released to shareholders or potential investors. The Quebec Act contains no provision for such confidential waivers. This issue will arise in full practical form if "cease and refrain" orders are authorized under the *Bank Act* as recommended in Chapter 6.

In his testimony before the Commission, Robert Steen, the Deputy Director of Corporate Finance for the OSC, took the position that disclosure to the investing public is the overriding concern, not the need for confidentiality respecting certain matters affecting banks.

The procedures of the QSC are similar in many respects to those of the OSC. The President of the QSC, Paul Guy, testified that the QSC has concluded that there is no reason to exempt banks from prospectus approval by securities commissions simply because such approvals may also be provided by the OIGB. Indeed, the QSC takes the position that it would be possible for it to decline to permit a bank issue in the Province of Quebec if it found the condition of the institution unsatisfactory on the basis of the financial statements or other public information, notwithstanding approval by the OIGB.

Legal proceedings under the Civil Code and an action for damages for false or misleading prospectus information were recently instituted by Quebec investors in connection with the CCB preference share issue in February 1985. The QSC has investigated the matter but its involvement in litigation has so far been confined to the issues of jurisdiction and the suitability of proceeding with the private actions in Quebec rather than in Alberta.

One final aspect of the law relating to securities transactions should also be noted. Section 358 of the *Criminal Code* sets out certain offences in connection with false prospectuses. The manner in which official investigations under this provision are carried out is relevant to the history of the CCB and the response of the OIGB to complaints dealing with alleged violations of the *Criminal Code*.

J. FOREIGN AGENCIES

The Inspector General maintains informal contact with foreign regulatory agencies, notably those of the United States. The contact serves two functions. First, when a foreign bank seeks to enter the Canadian banking industry by way of a subsidiary, the OIGB will seek confirmation from the home regulatory authority that the parent bank is in good standing. In some cases, the Inspector General will request more specific information. Secondly, when Canadian banks operate in a foreign jurisdiction, the local regulatory authority will acquire information from its inspections of the operations of the branch or subsidiary of a Canadian bank. That information may be communicated to the Inspector General.

In the case of CCB, both its L.A. Agency and its wholly-owned subsidiary, Westlands, were subject to supervision by various U.S. authorities at the state and federal levels. The FDIC and the FRB, whose general responsibilities are described in Appendix 2, were the principal agencies involved in supervision of the CCB. The OIGB was contacted on several occasions by U.S. regulators who forwarded information acquired in their inspections. Details of these contacts may be found in Chapter 4 and Appendix F.

During these contacts, the OIGB was informed of problems found in regard to management of the United States operations of CCB, and in regard to quality of the loan portfolios. Apparently both the U.S. federal regulatory agencies furnished copies of their 1984 reports to the Inspector General and to CCB. Neither the Inspector General nor the liquidator of CCB could locate and deliver copies of these reports to the Commission. It is the policy of the U.S. regulators not to release their reports to the public, directly or indirectly, and all copies of these reports apparently were returned to the U.S. agencies or destroyed by both the OIGB and the CCB, probably in accordance with a condition imposed by those agencies at the time of the delivery of these reports. The Commission is aware of the contents of some of these reports from other documents but has not seen these potentially important reviews of CCB produced in California in 1984 relating to the L.A. Agency and Westlands, the CCB subsidiary bank operation in California. This illustrates the complexity and delicacy of international regulation of banking institutions.

Northland Bank had no significant banking operations outside Canada which attracted foreign regulation.

Chapter 4

CCB and the Support Program: Commentary and Analysis

- **A.** Causes of Collapse of CCB
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C. Evaluation of the Supervisory Process

1. Management
2. Directors
3. Auditors of the CCB
4. The Inspector General
5. The Bank of Canada
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Chapter 4

CCB and the Support Program: Commentary and Analysis

This chapter contains commentary on the causes of collapse of the CCB, on the design and operation of the unsuccessful support program and on the conduct throughout the events in question of particular parties including the management and directors of the CCB, the external auditors, the Office of the Inspector General of Banks (hereafter, the OIGB), the Bank of Canada, the Minister of Finance, and the Minister of State (Finance). Appendices C and D set out in considerable detail a factual description of the evolution and eventual collapse of the CCB following an unsuccessful rescue attempt in the spring of 1985. Although the analysis is based upon the factual description certain descriptive material is repeated here for clarity and convenience.

A. CAUSES OF COLLAPSE OF CCB

During the course of the Inquiry, various possible explanations were put forward to account for the failure of the CCB. CCB's Chief Executive Officer (CEO) and President, Mr. G.W.C. McLaughlan, for example, listed seven principal elements as causes of the collapse of the bank:

1. The excessive concentration of the loan portfolio in two of the most cyclical industries, real estate and energy;
2. Excessive concentration of loan assets in Western Canada whose economy is based on natural resources;
3. The expansion program undertaken by the bank in 1980-81, which unfortunately coincided with the advent of a severe recession. The object of diversification was correct but it came at the wrong time;
4. Excessively large loans to individual borrowers in relation to the bank's capital base;
5. The decision taken in September 1981 to acquire 39 per cent of Westlands Bank in California;

6. The relationship between Mr. Leonard Rosenberg, and trust companies associated with him, and Mr. Howard Eaton, who was then the CEO of the bank; and

7. The inherent danger faced by a small regional bank in raising its deposits from the wholesale marketplace.

Although McLaughlan did not mention poor lending practices, other evidence suggests that CCB's credit granting procedures and policies led to the troubled loans which eventually became a deadly drag on the bank.

McLaughlan testified that the slide into liquidation became irreversible:

> It really started in 1983 ... Rosenberg was certainly the catalyst but it somehow masked the economic undermining of the bank that was occurring at that stage in terms of Western Canada and energy.

While McLaughlan subsequently came to the view that merger was the only solution to CCB's problems, he testified that this was not apparent to him until 27 February 1985. The following exchange concluded McLaughlan's testimony on this matter:

> Q: Why was the condition so deeply entrenched that it went two years before a banker of your experience realized it?
>
> McLaughlan: Because I had certainly concluded in terms of the U.S. energy loans, that the programs that had been in place were going to deliver the planned results. In terms of the balance of the problems in the bank's portfolio being primarily Western Canada, the recovery was underway and would have seen the bank slowly recover to respectable and stable profits. Until the U.S. energy loans collapsed I certainly thought we had reasonable chance of making it, a very good chance of making it. I felt very confident going into 1985 ...
>
> Q: And you might have recovered if either the western economy revived or the U.S. energy economy did not collapse?
>
> McLaughlan: Yes, I will answer that one without qualification.
>
> Q: So that is the history of the whole thing in two simple sentences?
>
> McLaughlan: It is a regional bank lending into two volatile industries with its deposit footings represented by again volatile depositors.
>
> Q: Could you say instead of regional bank a young bank?
>
> McLaughlan: Yes. I mean "region" just in the sense of concentration.

This section analyses the various hypotheses in light of the evidence presented to the Inquiry.

1. Weaknesses Inherent in the Original CCB Plan

As described in Appendix C, the sponsors of the bank perceived an opening or gap in the banking services provided in this country. CCB planned to operate as a commercial and wholesale bank on a national basis, and it would provide services related to merchant banking. The new bank would concentrate on commercial lending in a loan range described as mid-market. The founders believed, and Parliament was so informed, that the major banks did not cover this part of the banking spectrum where the loans were said to be riskier and indeed could not generally be obtained from existing lenders. The higher risks would be offset by a higher loan yield which in turn would permit the bank to finance itself through deposits from the wholesale money market at interest rates higher than those paid for retail deposits by Canadian banks in general. The bank learned well before its collapse that this plan was faulty. It attempted in early 1983 to shift its deposit base away from the uncertain and volatile wholesale market and deposit brokers to retail deposits taken through its own branches.

The evidence predominantly favours the conclusion that there was no market niche which had been overlooked by the existing banking industry. However, the four western premiers attending the Western Economic Conference in 1973 had urged the introduction of this very type of banking enterprise and received federal government encouragement. CCB's sponsors were congratulated by members of the Senate Committee on their initiative. The bank was seen in the West as well as by the federal government as being one which would "lend money where the established banks refused to lend". This was one part of the expectations of the founders which turned out to be true.

One possible answer to the question whether the need for the services CCB proposed to deliver to the community existed at the time of its inauguration has been suggested in the growth of the loan portfolio. However, it may not be satisfactory to conclude that the creation of a loan portfolio in excess of $2B within eight years of the bank's formation proves the existence of an unsatisfied demand for its banking services. The high proportion of unsatisfactory loans might indicate that in the conduct of its lending business, the bank artificially created this market for its services. In the circumstances it may be more accurate to say that CCB extended funding and banking accommodation to borrowers who did not have the will or the financial capacity to repay their loans.

The hazards of wholesale funding may not have been appreciated by CCB's founders in 1976. By 1983, at the latest, McLaughlan had concluded, "It is a very dangerous practice for a small bank, and particularly a bank based in regional areas, as this one was, with cyclical industries underpinning its economy to be engaged in raising its deposits from the wholesale marketplace". There were no dissenters from this view at this Inquiry.

Presumably, the new Schedule A bank was able to make a fast start in the lending business by large scale wholesale funding which eliminated the expensive and slow establishment of a national retail branch network. The price paid for this quick expansion and the avoidance of a high capital layout for a branch system was vulnerability to large-scale withdrawal of deposits in the downswings of the economic cycles, with critical consequences. Perhaps in earlier times when banks could not lend on real estate mortgages, and contented themselves with short-term and demand loans with a high rollover velocity, the consequences were less serious. The matching of liabilities and assets by term maturity was easy and the incoming and outgoing deposits tides caused less disruption.

The experience of the CCB in the final years shows the reliability of retail deposits. Their availability to regional banks was perhaps due to regional loyalties of the population. Until advances by the Bank of Canada reached inordinate levels and until the publicity surrounding the CCB support program intensified, retail funding remained with CCB at reasonably constant levels.

The designed lending policies of the bank somehow were not translated into a loan portfolio national in scope and diversified industrially. Indeed, the loan inventory took on the opposite characteristics, initially, no doubt, because its head office and its branches were all in the West. Because real estate lending was an easy way to advance large amounts of money relatively quickly, particularly in Alberta and British Columbia, real estate loans predominated from the earliest times in this bank. The same applied to oil and gas lending. This pattern of concentration was greatly accentuated by the extent of the Alberta economic boom of the 1970s and the early 1980s. Bankers new and old naturally joined the "gold rush" bonanza of demand for credit in these booming industries.

The day of reckoning came with the severe recession in the West, felt first through the National Energy Program which was accompanied by inordinately high interest rates, and followed closely by a decline in Alberta's terms of trade (the price of provincial exports relative to the price of provincial imports) largely due to the decline in world petroleum prices and North American natural gas prices. Borrowers in the West, and hence the banks themselves, suffered from the sharply declining values in their assets. The severe recession turned into a long one, and from the Alberta viewpoint at least, climaxed in late 1985 with an unprecedented collapse in world oil prices which saw the price of oil drop by $10 a barrel in a week. The five largest Canadian banks suffered in Alberta and British Columbia as did the two newcomers. While the significance of the western economic deterioration is discussed more fully below, these common experiences support the view expressed by Mr. J. DesBrisay, a founding director, that CCB was not "... based on taking over loans that other banks would not take... ", although he did believe that CCB loans held an element of greater risk. What is decidedly clear is that the new regional banks could not afford to court the same trade as the well-established national banks with diversified customers and diversified regions of operations. McLaughlan was no doubt correct in his July 1982 statement that, "our mid-market high growth clients are inherently weak in a difficult economic climate", and his testimony that the fate of the borrower is the fate of the lender because "... the position of the bank is really one of reflecting the condition or health of its customers."

The implementation of the bank's aim to enter the merchant banking field is more difficult to assess. By 1981, CCB had founded three subsidiary financial operations. The bank retained a small interest in each, and managed two of these enterprises under contract. None prospered. One was merged with the bank and consideration was given to the merging of the others with CCB as well, not because their future was considered to be attractive, but because the bank might thereby increase its defined capital. Bank management did not consider that any of these subsidiaries were well managed. The merchant banking aspect of the business plan of CCB simply did not work out.

The management of CCB raises other questions. As several witnesses have testified, it is difficult for a new and operationally restricted bank to attract senior management with experience in all important phases of banking from daily counter and cage operations to financing, accounting, corporate governance and regulatory matters. The importance of good management, especially in a new bank, cannot be overstated. The evidence clearly shows that corporate governance is the first and main defence of the bank against the hazards of funding, lending and loan management. It requires strict discipline to resist the temptation to grow too quickly and to match the nature, quality and term of the loan assets to funding liabilities. All this begins with skilled and experienced leaders in banking and they are difficult to attract to a small new bank.

The relationship between management and directors in the CCB was affected by the circumstance that the larger shareholders were directly represented on the Board. It was the opinion of more than one experienced banker that such an arrangement creates a potential condition of conflict in the directors in dealing with the interest of the shareholders at large and with the interest of the depositors. Others considered that the combination of professional managerial experience in banking and an independent board of directors selected from a broad cross-section of business experience and leaders in the community would produce a balanced, directing force for a bank superior to the board comprised of representatives of blocs of shareholders.

Thus, in summary, the following weaknesses in the original plan became apparent as the bank developed:

(a) There was no clear market niche overlooked by the existing banks for mid-market, above average risk commercial lending;

(b) Wholesale funding was a hazardous base for a small bank to build a loan portfolio of mixed term loans on. Too late the bank saw the attractive stability of retail deposits;

(c) The rapid growth of the loan portfolio necessary to establish interest income to support banking operations increased the risk of making unsatisfactory loans;

(d) High concentration of loans in cyclical industries and in limited geographic regions was fundamentally unsound and made the bank unduly vulnerable to downward economic fluctuations;

(e) Merchant banking did not prove a fertile source of revenue;

One thing did pan out. CCB was designed not as a regional bank but as a geographically-diversified bank, and with a little luck in its timing, CCB might have survived long enough to achieve that stature. Certainly under McLaughlan's leadership, efforts were being made to reduce CCB's regional concentration. At the end, 31 per cent of its outstanding loans were in Alberta, although, according to the 1984 Annual Report, 21 per cent of the loans were in Alberta, measured on the basis of loan authorizations which, on the evidence, were never fully advanced.

2. The Stewardship of Howard Eaton

Whatever defects may have been built into the bank from the outset, CCB sailed ahead with every indication of success from its opening in 1976 under the guidance of Howard Eaton, the first President and CEO. The phenomenal early growth of the CCB was produced from a banking plant which expanded rapidly and brought CCB to the top earning levels, measured by various ratios and percentages, amongst Canadian banks. In the words of DesBrisay, a long time director of the bank, the bank was "spectacularly successful ... we clearly, in our view, had highly competent mid- and senior-level managements. Our practices, we understood, were conservative." Bad loans were an experience which only lay in the future. All the evidence would indicate that at the end of fiscal year 1981 at least, the original plan, the founders' vision, appeared to be working well under Eaton's guidance.

This explosive early start coincided with the parallel climb of the Alberta economy. It was a dramatic boom, fuelled by oil and gas. As the oil industry accelerated, so did the real estate and construction industries. The associated prosperity manifested itself in many ways. Economic experts testified that the business community did not foresee an end at all, at least through 1981. Indeed, Dr. Harries, an economic consultant, testified that a prudent businessman in 1981 would not have foreseen the great downturn which began in 1982. In all this, the bank's customers borrowed money, reaped profits and borrowed more. Naturally, the banks rode the wave of prosperity like the rest of the business community. It was a rewarding experience and apparently regarded as an infinite one.

Then came the opening phase of the recession in the last days of 1980 when Alberta experienced extraordinarily high interest rates, the advent of the National Energy Program, and shortly thereafter a world-wide recession in the oil industry. The recession at the outset was seen, according to the testimony, as being one of moderate depth, and likely of short duration. It turned out to be the most serious recession in Western Canada since the 1930s. That the recession had a very large impact on these banks is, on the record in this Inquiry, undoubted. The cause or causes of the recession itself are not important and therefore are not further examined here. What is important is the magnitude of its impact on the banks and its relevance in determining the causes of collapse. The significance of the recession for the CCB is discussed below.

Even before the recession was recognized, the directors of the bank experienced some concern. Limits to real estate lending were mentioned by Eaton, but no precise controls were put in place. Eaton began to take initiatives on his own. Then it was rumored that Eaton was moving to

California. Indeed, Eaton caused CCB to buy a residence in Los Angeles for the purpose of dividing his time between California and Edmonton. DesBrisay also noted "an apparent growing isolation from the Board or an ignoring of the Board, doing things his way without meaningful board involvement".

Because the sudden growth in the bank in its opening years was largely keyed to loans in Western Canada relating to real estate and oil and gas, the bank became exposed, wittingly or unwittingly, to a risk of serious loss should the Western Canadian economy falter. It is not without irony that, induced by this overconcentration of loans in Western Canada, and in real estate and energy, the bank decided to diversify geographically and sectorally by moving into Eastern Canada and California. This was an expensive move and was unhappily undertaken just as the recession commenced. Thus the prescribed cure to overconcentration may have been correct, but by the time it was administered, it only aggravated the disease. The second part of this experience was the acquisition of a 39 per cent interest in a California bank, Westlands, which had a loan portfolio virtually all of which was in real estate. The move into California in reality increased the bank's exposure to cyclical businesses, for Westlands and CCB's Los Angeles branch loaned heavily in the real estate and oil and gas sectors. Westlands turned out to be badly run, underfinanced and excessively dependent on wholesale deposits for its lending funds. In McLaughlan's words, "by any measurement, this was an ill-conceived and improper investment". By 1984, a director of CCB concluded that the impact of the Westlands venture on CCB was "appalling". Westlands was an Eaton recommendation, opposed by some of the most experienced members of the board.

The Inspector General responded to the growing concerns surrounding Eaton's management by writing to all members of the Board to advise them that the chief executive officer of a Canadian bank must reside in Canada and that the Board should consider the appropriate action in the circumstances existing in CCB. It should be noted in passing that the intervention by the Inspector General, at first decisive, appeared to fade in the face of some opposition from Eaton to his suggested resignation. Indeed the Inspector General indicated his acceptance of a compromise and it was only subsequent developments which brought about Eaton's departure.

In the meantime, the background of the "Trust Companies Affair" was unfolding and Leonard Rosenberg became associated with CCB. By August 1982, the relationship between Eaton and Rosenberg had developed to the point where they proposed to buy from CCB its U.S.

interests under an arrangement which led the Board to appreciate, perhaps for the first time, that Eaton's sights had by then been transferred away from CCB and trained on other ventures. The Board "indignantly" rejected the proposal. Eaton left the bank in January 1983.

The residue of troubles left behind in CCB is well described by Eaton himself in a memo of May 1982. The recession, he stated, had produced $80M in nonearning assets and about $9.5M in uncollected interest of which about $3.8M had been taken into the bank's income statement. Eaton then had placed the bank management on an emergency footing and several drastic measures were announced. DesBrisay said of Eaton at this time, "The Rosenberg connection badly stained the flag of CCB." Loans were made by the bank to the Rosenberg group of companies and indeed some of the corporate manoeuvres of the group may have been indirectly assisted by CCB loans. Rosenberg, through several tentacles of the Greymac group, increased his shareholdings in CCB to about 30 per cent, well above the 10 per cent limit imposed by the *Bank Act*. It was at this point that the Inspector General stepped in, as mentioned above, by calling for some action by the Board. The whole affair indeed hung over CCB like a large black cloud in a heretofore clear sky. CCB's days in the sun were over, but only a few financial experts appeared to perceive it at the time.

The publicity of what has been called in evidence here the Trust Companies Affair led directly to large-scale withdrawal of deposits by the large depositors and professional money managers. Some deposits never returned to the CCB despite the considerable efforts of the McLaughlan management team. CCB immediately arranged for liquidity support from the major banks and had a stand-by understanding with the Bank of Canada for further support.

The testimony given before this Inquiry is divided as to the long-term effect of the Eaton era on CCB. McLaughlan did not agree when pressed on the point that the overexpansion of the bank under Eaton, and the subsequent Trust Companies Affair, were causes of the bank's failure. DesBrisay placed more emphasis on the irreparable harm caused by these two features of the Eaton era and concluded that they started the bank on a downhill slide from which it was unable to recover. However, he too, when pressed on the point, did not attempt to forge a direct link between the events leading up to the departure of Eaton and the ultimate collapse of the CCB:

> Q.: I was wondering whether this episode did not so damage the health of the bank that when it was infected with the deep and long-lasting recession it died

in the process. Had it not been infected, would it have survived? That is the big question.

Mr. DesBrisay: I do not know, sir.

3. The Western Economy

McLaughlan's assessment of the condition of the CCB when he took over as CEO in January 1983 was that the bank would survive. Looking back on the bank's history, he testified that he now realized that "short of a merger" he was not sure if it could have survived. He expressed his final conclusion on this point in his testimony this way: "The assets were there at that stage that were ultimately going to pull down the bank." In short, bad loans had been made which irreparably reduced the bank's earning power, and which would ultimately involve the bank's capital in repayment of maturing deposits.

DesBrisay offered a positive description of McLaughlan's early management:

> Gerry McLaughlan took over really with great confidence and great authority. He immediately exercised his influence, and he was good. He was a very, very dedicated bank officer. His staff was intensely loyal to him. He worked around the clock, and he had, I would say, great confidence. He generated great confidence in the board and great confidence in the people who worked very closely with him.

DesBrisay was also able to point to some concrete signs of a long-term turn-around in the bank in the months following Eaton's departure:

a) The Inspector General, at the conclusion of the 1983 annual inspection, rated the bank's internal control system A+, approved its interest accrual policy, and complimented the McLaughlan management team.

b) The liquidity advances were retired by the end of June.

c) $19.5M capital was raised by a rights offering to CCB shareholders in 1983.

d) By September, many of the Greymac shares in the bank had been acquired by new shareholders.

e) Paul B. Paine, a distinguished member of the financial community, became Chairman of the Board in November, 1983.

The realities of the condition of CCB's loan portfolio, whatever that condition might be attributed to, were the prime responsibility of the McLaughlan team. The roots of those loans which later caused serious problems in the bank reached back to 1981 and beyond. By 1982, everyone in management or on the Board was aware of the presence of a considerable number of unsatisfactory loans. McLaughlan volunteered the observation that there was "an excessive emphasis on growth". In a July 1982 memorandum, he had reported to Eaton that the nonperforming loans had reached "devastating proportions". Either the bank's lending team had followed a faulty plan or had simply made poor credit judgments. McLaughlan's memorandum, described in Appendix C, attributed the problems to both.

DesBrisay, in an undelivered statement prepared for a Board meeting in November 1982, recorded the observation that "our bank has always been adventurous" and stated that he realized that the time had come to consolidate or retrench. This was necessary because:

> During the past year, we have been told of substandard lending practices in our Vancouver platform and of our similar problems in Quebec and in at least one of our U.S. offices. We have heard of waste and inefficiencies in Bancorp. We know that Cancom Funds has been mismanaged. CCB Leasing, I understand, may have been misconceived.

McLaughlan joined CCB in October 1976 as Vice-President, Alberta. He became Senior Vice-President, Alberta and Saskatchewan, in 1979. In 1981, he became Chief Operating Officer, and ascended to President in 1982. His entire career in CCB was spent in Edmonton and mostly as part of senior management in the Head Office. It is fair to conclude that the McLaughlan team, when it moved to the top of the bank in 1983, took command of a loan portfolio which was worth by any standard of measurement less, and probably considerably less, than its principal value. This team was part of senior management when many of the doubtful loans were put in place. McLaughlan had always carried some responsibility for the Alberta lending.

Assuming that the portfolio was indeed worth considerably less than the values carried in the balance sheet in January 1983, several questions arise. Was the downturn in the Alberta economy an economic event of such proportion that a small new bank, however well and prudently managed, would not have survived, or was the recession the inevitable test of the lending practices of the bank which prudent management would have kept in mind in establishing those lending policies and practices? Was the failure of these lending policies and practices, and not the depression in the West itself, the effective cause of failure? Was the McLaughlan management team from January 1983 onwards contending in a long and deadly battle for survival of the bank against the combination of a large inventory of poor quality loan assets, all the evil infection which flows from that condition in a bank, and a profound economic decline in the bank's principal regional operation? If so, should CCB tactics, practices and performance, from 1983 to 1985 inclusive, be measured, not against the standards and principles followed by the major banks in their conventional operations, but against the conduct of management in an enterprise whose energies must be largely devoted to simply keeping the doors open? Corporate and professional misconduct is certainly not to be tolerated in any circumstances, but happily the record here assembled does not disclose dishonesty or other misconduct legally defined on the part of the senior managers of the CCB. The Inquiry of course has not pursued any events, circumstances and transactions not germane to its mandate, and an observation about legal morality can only be made with reference to the record before it.

Before examining these questions in the light of the record of the McLaughlan years, one should respond to the oft-repeated viewpoint that CCB did no better nor worse in these years than did the major banks in Alberta and British Columbia. From 1982 to 1985, 75 to 80 per cent of the Royal Bank of Canada's total domestic nonperforming loans (NPLs) were in Alberta and British Columbia. Two-thirds of the Royal Bank's domestic loan write-offs from 1980 to 1985, or $1.245B out of $1.853B, were in the same two provinces. Most of the Toronto-Dominion Bank's 1984 loan losses of $924M were in Alberta and British Columbia in the resource and real estate sectors.

There is little room for debate that the major banks encountered large losses in their western operations in these years. These losses were sustainable because of favourable offsetting experiences elsewhere. One must also appreciate that relative to their long and successful track record, their capital and surplus cushion, and their scale of operations, these losses were slight and without serious fiscal consequences. It is this structural strength that renders irrelevant the argument that CCB cannot be faulted for a loan loss experience in Western Canada which was paralleled by the experience of the major banks. A banker backed up by, relatively speaking, limitless resources, can undertake lending programs that would be fatal to a banker without such backup. Banking prudence must be measured with reference to the resources of the bank relative to the taking of the risks in question. The Royal Bank of Canada, the Canadian Imperial Bank of Commerce and other major banks undertook loans in the West in this period with an awareness of their respective financial depth. Many of these loans turned bad as the economy turned down. CCB had no monopoly on this experience. It was as improvident for the capital-rich banks to do so as it was for CCB, but the consequences were foreseeably different. Apart from their capital strength and depth, the geographically and sectorally diversified majors could rely as they did on the built-in stabilizer of a far-flung branch system which deployed their capital into more stable regions, noncyclical industries and developed economies in and outside this country. Widely distributed branches also afforded the major banks a stable source of retail funding from which to service their western and other loans. All this was in place when the major banks entered the credit fray in the western oil and real estate fields. CCB management had behind them none of these advantages when they pursued the tactic of quick growth in staff and facilities, created funding liabilities in a volatile wholesale money market, and deployed funds in making the loans which came to comprise its troubled loan portfolio. For these reasons a parallel between CCB and the major banks is interesting, but throws little light on the true and basic causes of the failure of CCB.

4. The California Operations

McLaughlan's early moves as CEO were to reduce expenses and the geographic concentration of CCB's loans. While partially succeeding in this, the bank fell behind in sectoral lending concentration. Real estate loan authorizations had increased, and by the end of fiscal year 1984, amounted to approximately 31 per cent of the loan portfolio. This was, at least in part, due to the acquisition by the bank of the remaining 61 per cent of Westlands in June 1984. The defensive measures of shifting funding sources from wholesale to retail proved to be expensive and slow, but necessary. By fiscal year end 1984, retail deposits constituted 20 per cent of total deposit funds, up from virtually zero in prior years.

The decision to develop a significant operation in California proved to be a serious drain on CCB. It is unclear whether CCB only intended to take a passive position in Westlands at the time it acquired the minority position, although there is evidence to suggest the bank was to be more than a passive investor. Certainly, some of its officers, including Eaton, were actively engaged in the bank and indeed borrowed significant personal funds from it. CCB had four out of eleven directors on the Westlands' Board. It is doubtful that Eaton ever intended, or if pressed, could have justified the venture as a dormant investment.

By the fall of 1983, the FDIC had issued a highly critical report on Westlands and CCB's involvement in it. The actual report was not filed with the Inquiry, but its damning contents became known and are described in Appendix C. The FDIC issued a lengthy Cease and Desist Order, listing a number of conditions which had to be rectified. McLaughlan acknowledged that the order was justified and without compliance with it Westlands would have failed. Accordingly, management was changed, the remaining 61 per cent of Westlands' shares were acquired by CCB, capital was advanced by CCB, and a large number of bad loans were transferred from Westlands to the Los Angeles Agency of CCB.

All this was undertaken to protect CCB standing with the United States regulators because Westlands' deposit-taking branches were vital to CCB if it was to remain fully involved in California. The CCB branch in Los Angeles was only a lending facility without deposit-taking rights. There were potential tax benefits as well, but these were available only if Westlands could be made profitable within the next few years by CCB's financial and managerial support.

The costs of all this to CCB were significant, including the investment in the bad loans transferred out of and the good loans transferred into Westlands by the Los Angeles Agency of CCB, and the diversion to Westlands of the income from a debenture which CCB loaned to Westlands. In the end, Westlands became profitable about the time CCB failed. Superficially at least, it can be said that the FDIC saved the subsidiary bank and killed its parent. Ironically, the surviving subsidiary was seen as necessary in the first place in order to save the parent by diversification of its banking activities. In the end the subsidiary dragged its parent down towards insolvency.

The immediate casualty of the Westlands rescue was CCB's Los Angeles Agency. It was regulated by another United States federal agency, the Federal Reserve Board. The FRB report on this Agency, described in Appendix D and issued around February 1985, could not be found in Canada. The evidence contains some conflicts about the fate of the copies of the report which reached both the OIGB and CCB. What is clear is that CCB transferred some loans out of the Los Angeles Agency to its head office in Edmonton in order to remove them from inspection by United States regulators. All these mechanics were undertaken by CCB to avoid or postpone write-offs or write-downs of the California energy loans. However, room for manoeuvre had, by the end of fiscal 1984, been seriously reduced. The Agency had become a mortuary for the dead and dying loans of Westlands. The FRB rated $108M in loans out of a loan portfolio in the Agency of $350M (U.S.) as "doubtful and substandard". By the time the FRB report reached McLaughlan in February 1985, he had become aware of the sharp reduction in value of the energy loans in the Los Angeles branch. It is also clear that when the Inspector General was given the FRB report, first orally and then by delivery by McLaughlan, he was not advised of the crisis in the bank by reason of the deteriorating condition of the U.S. energy loans. This takes on added significance when the action taken by the bank in early 1985 is reviewed in detail.

5. Management's Response

a. Accounting Strategies

The crises faced by CCB from at least 1983 onwards were continuous. Loans not being repaid on schedule were rising as a percentage of total loans. These loans were variously described in CCB (and indeed in other banks), as nonperforming, partially performing, unsatisfactory, marginal, nonearning, noncurrent and sometimes "bad". The CCB classified all loans on a scale of 1 to 6; the lower the number, the higher the quality. Class 6 loans required a reservation or write-down in value on the balance sheet, with a consequent charge against income in the income statement.

Faced with this rise in bad loans in 1983 through 1985, CCB had a difficult choice to make. If it called the loan and disposed of the security posted by the borrower in the Alberta and British Columbia economies then existing, the bank would take large losses. The evidence is that these losses would have exceeded the bank's capital. The bank would be insolvent by any definition. On the other hand, the bank could revise the terms of the loans in a number of ways in cooperation with the borrower. The primary object of the workouts (as such arrangements were known) in the circumstances of CCB was not to insure the survival of the borrower but, of necessity, the survival of the lender, the bank itself. Survival of the lender meant in short the avoidance of capital loss which would follow realization of the security. The survival of CCB therefore required that the problem loans in the bank be maintained at a classification above the level where a loss provision must be taken according to CCB's own rules, and income recognition cease. This consequence followed because the taking of a provision had two effects. First, it would diminish the value of the loan asset and the capital on the balance sheet. Second, the earnings of the bank would be reduced because a portion of a loss provision as defined by regulation is charged against the income of the bank.

Of this double impact, the decline of earnings is generally conceded to be the primary signal to the money managers and security rating agencies of troubles in a bank. These forces effectively determine a bank's access to the wholesale money market on which CCB depended for much of the deposits which it in turn used for the making of loans. Without deposits, the bank could not lend, at least not to its optimum capacity, within the permitted deposit to capital ratio. Concurrently, the loan provisioning process would reduce the asset value of the bank's outstanding loans. These reductions in assets had the effect of reducing reserves to the point of diminishing the bank's capital when the loan loss provisions became extensive. Again, a cyclical effect reduced the attractiveness of the bank to the wholesale money market and to potential investors. Thus the decay in the loan portfolio is fed back into the core of the bank, its capital, by two routes. All this is but to illustrate why a small bank with a narrow base and short history must be wary when the economy in its neighbourhood is in decline. Such a bank needs to avoid reduction of loans to the lower rating categories so as to thereby postpone or even avoid taking loan provisions or write-downs, to the extent that accounting propriety and banking practice will permit.

The evidence discloses that there are several accounting and credit processes open to a bank in these circumstances. The bank can reconstruct the arrangements for repayment of the loan by reducing repayment schedules, by reducing interest rates or by increasing, by valuation adjustment, the collateral security held by the bank. The bank might achieve the same result by finding a replacement borrower and financing its acquisition of the business or assets or the collateral security posted by the first borrower. There are almost endless combinations and variations of such schemes, as the explanation by Mr. R. Lord, one of the auditors of CCB, indicates in Appendix C. A workout was the technique immediately brought into play if a loan threatened to drift from a 4 or 5 into category 6. By reason of its business plan or design, the bulk of CCB loans were in classes 3, 4 and 5. A workout loan in CCB was usually classified as a 4 or 5 on the scale of 1 to 6. They were higher risk loans than the industry as a whole granted on the average. CCB employed various workout strategies in a very energetic drive by its management to save the bank. The intensity of these activities increased through 1984 and 1985. All of these measures had one thing in common: they were dependent upon the accuracy or propriety of management's constant expectation (or hope) that better times would return in Western Canada and in the Western United States where these problem loans were domiciled.

The serious and delicate situation of CCB is revealed by the state of its loan statistics over the early 1980s. In 1981, 3.2 per cent of all loans were classified 5 and 6 (that is marginal and unsatisfactory loans, frequently called in CCB "MARGUN Loans"). By January 1985, the proportion of MARGUN Loans was 32 per cent. The class 6 loans on 31 October 1981 amounted to about one per cent of all loans. By 1985, it represented about 10 per cent.

The specific provisions taken in the fiscal periods 1981 and 1984, expressed as a percentage of the principal value of MARGUN loans and nonearning loans (NELs), were as described in Table 4.1.

Table 4.1

	Margun Loans	NEL	Total Specific Provisions
1981	10.2%	34.1%	$4.3M
1984	1.5%	4.4%	$8.5M

The total loan portfolio grew from $1.3B in 1981 to $2.3B by the end of 1984. It is apparent that if the 1981 percentages of loss provisions were taken against the amount of the MARGUN loans and NELs in 1984, the effect on CCB earnings would have been calamitous. This is particularly true if class 6 loans were recognized in 1984 in the same proportion as in 1981. The impact is clear when one realizes that the earnings reported were $9.9M for fiscal year 1981, but only $804,000 for fiscal year 1984. The bank's vulnerability to decline in loan values had risen dramatically. The question is whether the classifications taken by management on loan assessments were motivated by traditional banking processes and considerations, or by a natural instinct for survival.

The workout strategies inaugurated by the bank entail, as has been seen, another flexible and subjective standard. Often, a new borrower (a newly incorporated share company, for example) was granted a loan by the bank to acquire the security held by the bank against the defaulting customer. The new loan commonly included as well monies to carry the interest payments for an initial period. Sometimes the interest was simply accrued. Bank accounting principles permitted recognition of this accrued interest in the bank's income if the borrower had an apparent cash flow. The recognized interest was fed into the income statement of the bank and reported as an asset on the balance sheet, its precise position on the asset side of the balance sheet being determined by whether it was capitalized in the loan asset or simply accrued and carried as an "other asset". For a struggling bank, these generally accepted (in appropriate circumstances) accounting principles had great advantages. Their propriety, however, depended upon a determination by management that this accrued interest, together with the loan principal, was "ultimately collectable" or that the value of security held exceeded the outstanding debt, both principal and interest. Similar considerations apply to the decision whether a loan loss provision against an account is necessary.

This opened up new vistas for management. The value of an asset is a market function which in turn depends upon the time available to realize the asset value in the market. CCB management took the view that the value should not be determined according to the depressed conditions in the western economy between 1983 and 1985, but should include an element which would reflect the value in the market after an expected recovery from the recession two or three years hence. Sometimes the time standard was more elastic, stretching to five years, and in one instance, seven to ten years. This projected value reflected management's view of the level of the economy in these regions in the future years under consideration. Furthermore, the rules adopted by CCB did not allow, let alone require, the evaluation officer to discount or bring back such future economic prospects and returns to the date of determination of value.

CCB management referred to this process as the determination of "baseline value". The attraction of this technique was that it permitted management under the pressures it was facing to produce good results in the bank's financial statements and to postpone the date of realization of value until those days in the undetermined future when the value of the security held would return to a more suitable level. This justified, in the meantime, the recognition of accrued but unreceived income, and at the same time, supported the bank's decision not to place the loan in a classification which would necessitate, even by the bank's own rules, the taking of a loan loss provision. The negative side of this process was that the divergence between the financial statements and market realities became greater and greater but nevertheless difficult to detect by most readers of the statements.

All this might indicate that the bank's financial statements, as prepared by management in the first instance, were fanciful, and that CCB's management was operating without any checks or reviews in those processes directly related to the solvency of the bank. This raises the important question of how the elaborate accounting and supervision practices prescribed by the auditors and the regulator could have failed to produce informative financial statements which would have loudly proclaimed the oncoming failure of the bank. This matter is more directly addressed in the concluding section of this analysis dealing with the performance of the auditors and the OIGB in supervision. It is necessary, however, to consider banking and accounting practices at CCB in further detail in relation to the initial issue, the causes of collapse. The use of baseline values and their effect on decisions taken in regard to interest accrual, loan loss provisioning and interest capitalization at CCB are significant elements in the timing at least of the bank's demise.

The auditors reported to the Audit Committee in 1984 that: "In certain cases the Bank establishes its internal estimates of own security values (baseline values) which are in excess of appraised values obtained from external sources. The rationale for using baseline values is that the appraisals were obtained in depressed markets and the Bank will control the property and dispose of it when the real estate market recovers. ..." Both management, including directors, and external auditors thus understood that the purpose of the process was to add significantly to the present worth of the security reported by the bank, as compared to its disposal value in the prevailing markets in the western economy.

This "future valuation" device was much debated in the evidence. CCB management considered it to be a procedure whereby "going concern" value could be determined. Any other valuation such as that employed by the bank inspection teams (who, as will be seen, inspected the loans in CCB in 1985) was viewed as "liquidation" or "fire sale" value. All other witnesses who testified on the subject, including the succession of bank credit officers from the major banks who examined the loan portfolio of CCB, the senior officers of the six large banks, and expert witnesses in bank auditing, rejected the concept of determining present value by gauging the level of the economy at some specified or unspecified time in the future, particularly when such supposed future value is not by the formula brought back to the present. None of these witnesses considered that a disposal of security within a reasonable time was equivalent to a forced sale or a liquidation sale. All these witnesses stated that their institutions did not include future values or an assumption of a return to prosperity in the present value of an asset.

The practice in the United Kingdom according to Charles F. Green of National Westminster Bank is to value security, where the borrower's covenant has failed, on a forced sale basis. Our practice in Canadian banking is generally otherwise. However, the determination of present value on the basis of future expectations is a denial of the purpose of the exercise. Financial statements are stated to be a reflection of the financial position of the institution at the effective date of those financial statements. If the principal asset of the institution, here a bank, is valued on some basis which does not reflect the present worth of that principal asset at the effective date of the financial statements, then the accuracy and the worth of the financial statements are destroyed. Worse still, anyone relying on a financial statement without an awareness that a technique such as baseline value had been employed with reference to the principal assets would be seriously misled.

Interest capitalization became an important issue in the evidence surrounding the operations of CCB. The extent of the practice of interest capitalization in CCB was indicated in a report prepared in June 1985 by the accounting staff at the head office of the bank from returns filed by all branches pursuant to detailed instructions from headquarters. The June 1985 statement revealed a total of $53M of capitalized interest on Canadian loans. The United States loans included an additional $6M of capitalized interest. The reports covered the fiscal years 1982 through 1984 inclusive. Management sought to discredit its own report when it was brought to their attention by the liquidator and by Commission counsel. McLaughlan had previously said in evidence that the bank had been unable to produce reliable evidence on the extent of recognized but unreceived interest. No mention had been made of the June report.

The likelihood of the general accuracy of this report is increased by the fact that the comptroller one month later directed the bank staff to record capitalization of interest prospectively. For this purpose, he reissued the instructions for compiling the report in June. The instructions included an exemption from reporting where capitalization is accepted in bank accounting principles as proper, such as in construction and other loans where it it is provided for in the original loan arrangement. Both management and external auditors considered these instructions adequate for this purpose but not for the retrospective compilation of capitalized interest. This goes only to the question of how much legitimate capitalization of interest was included in the $59M.

The earnings of CCB before taxes in these three fiscal years was, in all, $17.8M. Had this uncollected interest not been taken into income, the bank would have shown a loss of about $41M. If only 50 per cent of this uncollected interest was not properly recognized as income, the loss suffered by the bank in these three years would have been about $12M. The value of the loans would also have been overstated by the same amount, thus distorting the balance sheet as well as the statement of earnings. Of course, some (and probably most) of the loans in question should have become nonearning loans and classified downwards but for the recognition of this unreceived income, and loss provisions would, of necessity, have been taken in many cases. This would have reduced the appropriation for contingencies account in the balance sheet of the bank. The materiality of this failure to take adequate loss provisions is seen when it is appreciated that the capital of the bank at the end of the fiscal year 1984 was only $120M, and earnings in these periods would have been erased.

What remains unexplained is the failure of the auditors to come across this apparently widespread activity, and to report upon it in one of many ways. The evidence is that in the course of the annual audit, the auditors examined more than 60 per cent of the bank's loans. Such a wide sampling must surely have uncovered the practice when it had been followed on this scale or even anything approaching such a scale. The auditors had discussed this matter with the Audit Committee of the Board. In 1983, their report to the Committee stated that: "The bank's policy of capitalizing interest on problem loans increases the difficulty in demonstrating full collectability of these loans." In 1984, they returned to this question: "We have the feeling that the bank is somewhat more aggressive in its accrual and capitalization of uncollected interest than we would prefer. ..."

On all the evidence, one must conclude that, in all probability, the practice of recognition of uncollected interest income, either by capitalization or by accrual, was widespread in the bank. The conclusion is irresistible that in the effort to show earnings and to protect capital to the last possible moment, management was overborne by the overwhelming flood of unserviced loans of all classifications in the loan portfolio and took refuge in this operational and accounting procedure beyond anything permitted under the principles of prudent bank management or bank accounting. One must also conclude that there was a clear awareness of all this in the auditors and that they failed to adequately respond.

Underlining the whole issue are the rules of the road in banking as to the classification of a loan as nonperforming, and the consequential decisions on when uncollected interest should be taken into income, when accrued interest should be reversed, and finally, when a loan loss provision with respect to a specific loan becomes mandatory. Some of the major banks have different approaches. The Toronto-Dominion Bank had the strictest rule in that "interest contractually due past 90 days" automatically classifies a loan as nonaccrual. The loan may also be classified nonaccrual if management considers there is doubt about the collectability of interest or principal. Once a loan is classified as nonaccrual all uncollected interest previously recognized as income is reversed and carried against current income. There is no management "override" in the Toronto-Dominion unlike the other major banks where management may forestall a nonaccrual classification of a loan when there is no reasonable doubt as to collectability of principal and interest. However, the chief executive officers of these banks stated that the exercise of management's override is "infrequent", "seldom used", or its "use is unknown". Fuller details are set out in Appendix F.

CCB on the other hand changed its practice in 1982. A memorandum from the comptroller to McLaughlan stated the auditors would question the fact that "we have changed our policy on accruing revenue on NELs. This has resulted in substantial income being recognized in fiscal 1982". This turned out to be a correct forecast. The auditors advised the Audit Committee at year end 1982: "We pointed out that the bank .... had changed its procedure for recognizing interest that is in arrears."

From all this, and from the internal reports in CCB at the end of fiscal 1984, it is apparent that the bank followed less conservative practices in the area of income recognition by the use of the management override than did the large banks. The record indicates that this practice, coupled with its interest capitalization policy and the avoidance of specific provisions on a large scale, produced results that distorted the financial statements of the bank. The precarious condition of the bank would naturally influence management's decision in all these practices and such was the case in CCB. Survival accounting was adopted by the McLaughlan team and largely accepted by the auditors and, as shall be seen, the regulator alike.

Furthermore, in CCB it can be said that management's practice in specific loss provisioning was accepted by the auditors as a fair presentation of the financial position of the bank. Whereas in the Canadian Imperial Bank of Commerce the rule for provisioning states, "A specific provision should normally be established where there is reasonable doubt as to recovery and the outcome is dependent on factors that cannot be forecast with reasonable assurance," CCB took such action only when loss was known to have occurred or was likely to occur. This process was accepted by its auditors. The Clarkson Gordon auditor of CCB stated, "... in many cases it is the bank's decision with respect to how they are going to manage that account that determines the appropriate accounting treatment."

The CCB pattern started, as mentioned earlier, with the bank's decision to revise its arrangement with the borrower by one form of workout or another. The underlying security was valued on the basis of future prospects and the borrower was seen as able to carry the loan by either performance or by the value placed upon the security held by the bank. The loan thus stayed outside the "nonearning" category so that no provision was mandated and none was taken. Survival accounting was as active in protecting the bank's assets as in protecting its income statement. There is no other conclusion open upon the evidence seen by the Inquiry. CCB, by the application of the provisioning policy of the major banks, would have slipped into insolvency at least by the end of fiscal year 1983.

Thus it is clear that management saw that the only hope of survival was to take to one or more of the following lifeboats: (a) recognizing questionable accrued interest (which by definition has not been received in cash) as bank income; (b) postponement of the decision to make a specific loan loss reserve; (c) the establishment of security value on the basis of future values; and (d) other related measures. All this was done in the hope that the recession in Alberta and British Columbia would pass or at least moderate, that the value of its assets would revive, and that the bank's middle market borrowers would return to some measure, at least, of the prosperity they had known before 1982. In fact, none of this happened. In August, 1983, McLaughlan, by a memo, instructed Mr. D.E. Smith, a senior officer of the bank, to classify a group of 16 loans as No. 4 and not to classify them as NEL, so as to "avoid a year end reservation." Two years later, about one-half of these same loans were included in the CCB Support Package and were sold or "participated" out of the CCB portfolio into the hands of the participants in the support group, as bad loans in whole or in part. An even more serious condemnation of CCB stewardship of its business rests in the fact that no provision for loss had been made against most of these loans right up to the day of reckoning in March 1985.

This raises a question which has recurred again and again in this Inquiry: At what point is the good and even courageous intent of management to save the bank and avoid all the losses entailed in its failure, overtaken by a duty to disclose to the shareholders, the regulators and, indeed, to the public at large, the serious condition of the assets of the bank, its declining earnings, the unsatisfactory ratio of capital to liabilities, or any other circumstance that posed a reasonable threat to the solvency and continued existence of the bank?

The drilling program in California illustrates the point. CCB financed the purchase and operation of a repossessed rig to drill a well using for that purpose the services of a CCB borrower who was unable to service its indebtedness to the bank. The bank stood not only to gain by repayment of the old or new loan, but also stood to receive a participation in an oil discovery should one occur. The bank undertook the drilling rig support program to avoid or at the very least to postpone suffering a write-off of loan assets or a reduction of interest income. This started in 1983, and by 1985, despite rosy predictions along the way, losses had to be recognized by the bank in the amount of $57M (U.S.) out of an energy portfolio of $85M (U.S.). A vice-president of the bank located in Los Angeles, speaking of the oil rig workout loans, revealed much when he wrote as far back as April 1983:

> You will appreciate that the program described above is not without considerable risk to the bank and goes beyond ordinary lending criteria. The willingness of the bank to undertake such risk is a reflection of the concern over the nonearning rig loans and the conclusion that the risks are worth taking, subject to scrupulous engineering, to avoid substantial and unpalatable write-offs.

All of this was considered unacceptable by the Federal Reserve Board on its examination of the Los Angeles Agency where these loans were held. In reporting to the Inspector General by telephone, the FRB expressed a concern not only for the L.A. branch, but for the continuance of CCB itself. In contrast, the Inspector General accepted the explanations of management of these losses and of the FRB criticisms. The Inspector General saw nothing in all this which "would bring the bank down". Management later said this was indeed the cause of the bank's failure although the record would indicate that at the most, the oil venture in California was only one of the last straws that broke its back.

Throughout the same years the bank also undertook workouts in Canada. New companies were created to carry old loans. Security held by the bank was turned over at book value to new borrowers financed by the bank by means of loans to a shell company created for the sole purpose of acquiring the security. The new borrower, by design, had no other assets, and the bank held no guarantees from its owners. Effectively, the new loan was made without recourse. The new borrower's investment was to be expertise and sweat, but not funds. By 1984, the bank had loans in this category with outstanding balances in excess of $350M out of a loan portfolio of $2.2B.

There are many examples of the extent to which the bank would go to keep up the appearance of a prosperous and solvent bank with a productive portfolio of loans. Though the motives of management and their courage in the face of impending doom may be commendable, the fact is, they knew better and they put new investors and depositors in the bank at great risk.

An even more serious question than the adequacy of management's performance in all this, is the position of the auditors and the state agencies comprising the supervisory framework. Their involvement was central to CCB capital issues where the interests of shareholders, other investors and depositors are in potential, if not real, conflict. The bank, from time to time throughout its career, raised capital for several purposes and by several means, including public offerings, private placements, the sale of equity, and the sale of debt securities. In addition to the need for capital to support loan asset growth according to established ratios, there is a further need in a bank to bring in capital. The market may perceive other advantages less susceptible to mathematical precision such as a larger buffer of capital upon which depositors may rely. Furthermore, the very fact that there are public investors with confidence sufficient to participate in the equity of the bank is a stabilizing factor in the market, and an aid to the attraction of deposits.

b. Need for New Capital

By 1982, and increasingly in 1983 and 1984, CCB felt the necessity to raise equity capital to support its diversification program in Eastern Canada and in California. By that time, it was also contemplating the purchase of the remainder of the outstanding shares in Westlands. These set-backs caused by the deep and prolonged Western Canadian recession, together with the stain which the Trust Companies Affair left on the bank, contributed to the need for the infusion of new capital. To this end, CCB prepared and executed a preliminary prospectus in 1982 for the issuance of preference shares to the general public, the actual sale being scheduled for early 1983. This program was abruptly ended by the Trust Companies Affair. In the course of 1983, CCB did raise $19.5M by a rights offering to existing shareholders, and while this may have been the best available capital program during 1983, it still left an unsatisfied corporate appetite for paid-in capital.

In the spring of 1983, after the Trust Companies Affair ended progress on the planned preference issue, the bank reopened discussions with Dominion Securities Pitfield, apparently because of improved conditions for such an issue by CCB. By the end of the summer the underwriters began in earnest to prepare a prospectus for a public issue. Three serious problems faced the bank and its underwriters in connection with the proposed underwriting. There was a tax problem relating to refundable dividend tax and an accounting problem concerning a switch by the bank from a cash to an accrual basis for commitment fees during the first three quarters of the 1983 fiscal year. Management, the underwriters and the external auditors recognized the existence of a third and more significant problem which had arisen in connection with the nature and extent of disclosure of nonearning loans. Management discussed this matter off and on and by 10 August 1983, an inter-executive memorandum referred to the problem:

> In preparing the unsatisfactory Loan Report the Credit function has chosen to compare outstandings with "loan value" as opposed to "appraised value" with the result that the shortfall appears to be increased materially. In view of the circumstances that see the Bank endeavouring to effect recovery by holding the various assets until the market returns it seems rather unrealistic to be discounting the appraised value to a loan value to effect comparison with outstandings.

It should be explained that "loan value" refers to a percentage of the value of underlying collateral, which varies with the nature of the collateral, against which the bank will lend. The "shortfall" refers to the difference between the outstanding amount of the loan and the loan value.

By the last week of August 1983, the bank and its advisers were still operating on a timetable which would see the preliminary prospectus signed and filed on 13-14 September. Preparatory to such filing, the President was delegated the task of reviewing and up-dating the nonearning loan section of the prospectus "using the Royal Bank of Canada Prospectus as a guideline".

In the Royal Bank prospectus, which was issued in early 1983 in connection with an issue of preferred shares and warrants, extensive disclosure was made of "nonproductive loans" which were defined as loans where "interest remains uncollected for 90 days beyond the scheduled due date" without any management override provision. The prospectus went on to state that the term "nonproductive loan" would also include any loan where "there is doubt as to ultimate collectability". In all these loans the Royal Bank stated that its policy was to "reverse previously accrued interest which has not actually been collected". In its prospectus the Royal Bank then set out the specific provisions for probable loan losses in connection with the loans in this category and proceeded to disclose the resultant nonproductive loans net of specific provisions for losses for the 5-year period prior to 1983. By

26 August, CCB management listed amongst the critical issues surrounding the preferred share issuance "the treatment of nonearning loans in [the] prospectus".

A second meeting of the working group on the proposed prospectus occurred on or about 1 September and the external auditors who were in attendance recorded the proceedings at that meeting. The three problems adverted to above were again mentioned with the observation that these problems could "effectively stop the prospectus from proceeding". The second problem, being the accounting difficulties resulting from a switch by the bank from cash to accrual for commitment fees in fiscal year 1983, was reiterated without any reference to any discussion about any other change in accounting bases occurring during the fiscal period. Specifically there was no mention of the adoption by the bank of any different accounting or other standard for the valuation of security held in the loan portfolio. The minute of the meeting as prepared by the external auditors states: "We were later told that a recent Royal Bank Prospectus had a rather extensive disclosure on the nonearning loan position of that bank and the disclosure was more extensive than our client felt they could have and still have a successful issue." This minute discloses no explanation for the discontinuance of the plan to file the draft prospectus on 13-14 September.

It is significant that on 14 September management distributed to regions and branches a directive concerning "Marginal/Unsatisfactory Loan Report". The memorandum opened with a discussion of the "Annual Report — September 30th ... Marginal/Unsatisfactory Loan return" and stated that such return would be expanded to include "security evaluation and reservation rationale". For this purpose the memorandum introduced two new sections, numbers 6 and 7, which were to be added to the annual return to head office. Section 6, "Detailed Security Evaluation", stated in part as follows:

> This section will provide the platforms['] best estimate of the eventual recovery value of the security pledged to the Bank and the borrowers['] willingness and ability to repay Bank advances.

The section goes on to describe "Methods of Evaluation" and refers to the establishment of "the recovery value of pledged asset", and then continues:

> This "baseline value" is the price at which the asset will change hands between a willing buyer and a willing seller. The recent recession has for example caused real estate prices to fall very quickly from a record peak to well below "baseline value".

The memo discusses the determination of this value by taking into account the time which will be required for prices, particularly for real estate, to return to acceptable levels.

> The length of time to sell assets has however increased from 1 to 2 months in 1981 to 12 to 24 months.
>
> This time period required to attract purchasers at "baseline values" is "sell-out time". For most areas of the country where recovery is well underway this required timing can be projected with some certainty. "Sell-out time" of the assets should be included in your evaluation comments.

Notwithstanding the fact that the valuation was being worked out at the end of the reporting period, in this case 30 September, the memorandum of instruction went on to state:

> However, in establishing the recoverable value of the assets, the time required to sell the asset should not be discounted from the value. Security evaluations are based on principal recovery only.

The memorandum significantly concluded:

> We appreciate the additional workload placed on you at this busy time. The early dispatch of these instructions will allow much of the work to be completed prior to September 30, 1983. We would like all of the reports in our hands by October 11, 1983.

The external auditors, by a memorandum dated 27 September, advised management that in their valuation of loans, the auditors' approach "would be much the same as last year ..." and would be based on a random selection from the loan portfolio. In this connection the memorandum stated: "We agreed that we would work from the September 30 unsatisfactory loan report *which will be available the morning of October 12*" (emphasis added). There is no indication in this memorandum that the auditors had been advised of the instructions to the field staff of the bank contained in the memo of 14 September. Indeed, the evidence of the auditors given to the Commission is that they were not aware of the memorandum. They added that it would have made no difference to their work if they had known. This may be some indication of the failure of the auditors to appreciate the full consequences to the bank and to the investing public of management's business strategy in the event the economy did not recover and bring asset values back with it.

One would expect to find reflected in CCB's Marginal and Unsatisfactory Loan Reports for the months of August and September the contrast between the loan portfolio valuation made prior to the memo of 14 September 1983 and that made subsequent to that memo.

The record reflects the statement for the month endings 31 August 1983, 30 September 1983, and 31 October 1983. The nonearning loans increased from $187M in August to $199M in September and then decreased to $127M in October. Superficially, one might expect a decrease in the September totals; however, management testified that the write-offs are based on the September reports, that the bank worked hard to wrap up outstanding matters in relation to nonearning loans at every quarter end, and that the auditors based their work primarily on the September reports. It may well be that this trend can be detected at the end of prior fiscal periods, but a decline of $70M in two months must require the receipt of considerable interest income from theretofore barren loans in the months of September or October. There may be the alternative explanation that there had been 100 per cent write-offs of NELs in the two-month period in question so as to reduce the number of loans in that category when expressed as a proportion of the total portfolio. This does not appear to have been the case. An internal bank document for the year end 1983 shows a total write-off on loans for the entire twelve-month period of $13M. By the end of August 1983, $12M of these write-offs had been budgeted. However, it is somewhat difficult to make this comparison because the form of reporting changed between the end of August and the end of October.

In any event, there is a primary problem of determining what would have been the result in October if the pre-14 September 1983 marginal and unsatisfactory instructions had been applied instead of the new section 6. It follows that the complaint by management of the practice of reducing appraised value to loan value as in the memo of 10 August 1983, by the issuance of instructions in September 1983 had the desired effect of reducing write-offs and provisions, and of reducing the percentage of nonearning loans in the total loan portfolio. The two monthly statements showing a large decline in NELs between 30 September and 31 October appear to bear this out because the full management analysis of nonearning loans and write-offs are based on the September report. All this activity confirms the expressed intention of management to overcome the difficulties created by the recent Royal Bank prospectus and the high level of NELs in CCB at 31 July 1983, for the purpose of proceeding with a share issue on the basis of the improved picture of NELs in the financial statements at the end of the fiscal year 1983, instead of using figures based on the former loan valuation standards.

A more detailed examination is required to demonstrate whether the evidence truly supports this conclusion. The report compiled on marginal and unsatisfactory loans on 30 September 1983 makes no mention of the instructions of 14 September 1983, nor does it indicate any write-offs or loan loss provisions related to any of the 90 loans included in the compilation. It should be observed in passing that 40 of these loans showed that accrued interest was taken into revenue.

The records of the underwriters, Dominion Securities Pitfield, confirm the management memorandum quoted above. On 12 October the underwriters, while proceeding on the new timetable, reviewed the history of the planned issue and the then current problems.

> This [the earlier work on a draft prospectus] all seemed to be very positive and work was proceeding toward a filing in early September.
>
> 3. We had asked Gerry McLaughlan to draft the section on Nonproducing Loans and he finally called a meeting of Lanny Mann, himself and myself during the course of my second visit to Edmonton. At that time, he surfaced the fact that they were not prepared to disclose the level of nonproducing loans since it was approximately 9.7 per cent of total loans and he viewed this figure as unacceptable for publication. He wondered if there were ways around this nonpublication. I indicated to him that there were precedents in various directions on the topic, however, I could give him absolutely no assurance that disclosure of this would not be required by the Securities Commissions. Further, I indicated to him that if the Securities Commissions were doing their job, it was my view that indeed this should be disclosed. In further discussion, I did go as far as to state that I would want to consult with my partners before a final decision were taken but indeed we might well require disclosure of this in the preliminary prospectus since it is an extremely central statistic to the bank's current position. McLaughlan seemed to entirely understand this and moved quickly to mothball the issue since *he is convinced that the statistic will look a great deal better at year end since they are carrying out a detailed loan-by-loan analysis which will lead, he assured me, to a substantial improvement in the balances.* (emphasis added)

McLaughlan, when confronted by these documents, testified that in addition to the problems noted by the underwriters, he was concerned with the reticence of the shareholders of the bank "going public", the offering of stock in a prospectus not founded on recent audited statements and the disclosure of outstanding litigation. Any question of reticence by existing stockholders to have the bank go to the public for funds must surely have been overcome when the draft prospectus was approved for the aborted issue of shares in 1982. As to the second concern, when the timetable for issue of a prospectus on 14 September 1983 was adopted, year-end audited statements more recent than 31 October 1982 were obviously not going to be available. A reference to the difficulties in revealing outstanding litigation is likewise of little true value. When the CCB Real Estate Investment Trust (REIT) offering was made in 1985 more serious litigation was outstanding, and the bank's financial condition was worse than at the time the 1983-84 issue was being prepared. Reference to litigation outstanding is a common element in stock issues.

As to the problem of disclosing a high percentage of nonearning loans in the bank's loan portfolio as they stood at the end of the third quarter, 31 July 1983, McLaughlan said his concern was not for the success of the share issue but rather with the impact such disclosure would have upon the depositor market. It is difficult to see how one could not be concerned about the saleability of equity to public investors but at the same time have a concern about the effect of historically high nonearning loans upon purchasers of debt instruments of the bank. The depositor outranks the shareholder in any circumstance in seeking recovery of his investment and is not dependent upon the earnings of the bank in order to realize upon the deposit. The depositor is able to choose the time for liquidation of his deposit either contractually or on demand, and its face value does not fluctuate with the stock market but is the principal secured by a debt instrument. The wholesale money market is certainly volatile but it is difficult to believe that the feared disclosure would not unsettle the purchaser of a locked-in investment in equity but would upset the short-term depositor who is always poised for escape in any event.

The auditors proceeded to complete the year end statements acting upon the statement of marginal and unsatisfactory loans made up by management effective 30 September 1983, pursuant to the memorandum of instruction circulated throughout the bank on 14 September 1983. The preference share issue eventually resulted in $35M being received from the investing public in early 1984.

What is startling is that none of the major actors in this capital issue, that is management, auditors and underwriters, seemed much concerned about the Inspector General's role or what that office might do when faced with a prospectus in support of such an issue. Disclosure was viewed as a matter vital to the underwriters who also saw that the provincial securities commissions would have to be faced. Management undertook to clear away the burden of disclosure by reducing the NELs to tolerable limits. The route and the measures taken were not disclosed to or discovered by the auditors or the Inspector General although clearly both were aware the CCB was, at least to some extent, by that time employing the baseline value concept in assessing the value of security held by the bank. The Inspector General, acting pursuant to the *Bank Act*, approved the prospectus in January 1984.

The timing and the effect of the bank-wide instruction of 14 September 1983 is of great significance. The memo at least accomplished two things: it implemented baseline value across the board, and it thereby effected a change in the bank's accounting and disclosure policies as regards both the regulator and the public who might take recourse to the financial statements of the bank. Certainly no effort was made by the bank to advise the auditors, the Inspector General, the Securities Commissions or the underwriters of the memo, its purpose and effect. The bank was driven to present financial statements which would support a prospectus for a public offering for much needed capital. The episode is even more consequential in assessing the performance of the other two elements in the tripartite supervision system, the external auditors and the Office of the Inspector General. Although the disclosure of NPLs in the prospectus was not contained in the financial statements set out in the prospectus, the conclusions reported on the level of NPLs would of necessity be drawn from the same financial records and information as were the statements approved by the auditors as at 31 October 1984.

6. State of CCB by Fiscal Year End 1984

To the end of its fiscal year 1984 the course taken by management in the bank's daily operations, which has just been reviewed, brought about certain results, mostly unfavourable.

1. The financial picture presented by the financial statements of the bank did not reveal the true state of affairs in the bank.

2. By forestalling the arrival of discernible insolvency the cost of ultimate failure to all concerned was increased.

3. Both investors in shares of the bank and depositors were misled if, as must be presumed, reliance was placed upon the bank's financial statements regarding some important matters, principally the state of the principal assets of the bank (its loans) and the bank's true income.

4. When the condition of the bank was revealed to officials of the Government, both executive and regulatory, in March 1985, the obfuscation of the financial statements by the survival tactics adopted by the bank interfered with a complete understanding of the state and needs of the bank and may well have defeated the attempts by the Government and by the major banks to save the bank from liquidation. Alternatively, this conduct by management and the reflection of the bank's affairs in its financial statements may have led the parties to the rescue program into a venture that in cold reality had no hope of succeeding except perhaps at an intolerable cost.

This calls for the examination of a more serious issue: whether there can properly be a publicly funded rescue of a bank which has, as was the case here, passed beyond the point of a mutually voluntary merger with another bank. To lay the ground work for this discussion the events from the end of fiscal 1984 to 14 March 1985 must be briefly examined.

By late 1984 it should have become clear that this was not an enterprise on the verge of a breakthrough to prosperity. It was descending rapidly into liquidation and the causes had been with it for some time, some would say since 1982. It is important to determine when awareness of this perilous state came to management, the directors, the auditors, and the Inspector General; and what each of them did about such knowledge if and when it came to them. If it never came, the issue is when they should have become aware of the bank's terminal condition from information at hand or available on reasonable inquiry having regard to their position, responsibilities and powers. Finally there is the issue whether there is any evidence of active deception or wilful blindness.

McLaughlan's testimony is revealing. He stated he was "guardedly optimistic as fiscal year '85 opened" because first quarter earnings were ahead of budget and the OPEC price drop much rumoured had turned out to be only $1.00 a barrel. The facts are otherwise. The bank had an operating loss the first quarter of 1985 of $2.35M (only a loss of about $1M had been budgeted) and only by claiming tax loss credits was a book profit of $200,000.00 produced. The Federal Reserve Board conducted an annual examination in October 1984. Their report was known to McLaughlan by 12 February 1985. The FRB's view was that 30 per cent of the Los Angeles Agency's loans were "unsatisfactory" and the condition of the Agency was "poor". It considered that the status of the Agency must raise a concern for CCB as a whole.

On 10 December 1984, Divisional Vice-President, Special Credits, U.S., Mr. E.J.D. Pinder, wrote a memo to Mr. R.G. Heisz, Executive Vice-President, U.S. Banking, anticipating losses in the United States Division from $7.15M to $45.15M depending upon the view taken of impending events, and that some accounts would "require reservations this year and we should begin to factor this reality into our planning. ..." This view was reiterated by Heisz at a meeting on 30 January 1985 when he stated that there would be "substantial additional write-offs". There was no indication that the measure was precipitated by an OPEC oil reduction of $1.00 a barrel on 30 January 1985.

There was evidence that the FRB had required United States banks to write off oil and gas loans two years earlier. Allan Taylor of the Royal Bank of Canada had been aware that the United States energy sector had been as described by the FRB two years earlier. Other witnesses from the major banks expressed similar skepticism about the CCB explanation of the suddenness of the CCB collapse as due to the sudden failure of United States energy loans.

The situation in the bank's Canadian operations had also continued to deteriorate. By 31 January 1985, nonearning loans had risen to $256M, and MARGUN loans to approximately $800M. Of the 250 loans reported as marginal and unsatisfactory, many had been in that category for at least two years. The instruction issued on 14 September 1983 by the head office of the bank for evaluation on the basis of baseline value placed a two-year limit on the time for realization of value. The liquidator of the bank, Mr. G. MacGirr, noted in his testimony that those loans which were unsupported by cash payments had become such a drag on the bank that the interest spread had disappeared by early 1985. Without net interest income, deferred taxes were of no help to the bank. Its cash income had dried up. No bank in this condition had a future and the CCB was no exception. By 6 March the Director of the Inspection Division of the OIGB, Mr. N. Grant, had reached this conclusion.

The role of the OIGB in the merger of the CCB REIT into the bank should be mentioned here. As described in Appendix C, the OIGB received preliminary and final prospectuses on 22 January 1985 and 4 February 1985 respectively. The Director of the OIGB Inspection Division, Mr. Grant, had determined after the May 1984 annual inspection that notwithstanding the "satisfactory" rating accorded the bank recorded in a report prepared in the OIGB, CCB should be classified as "unsatisfactory". The Assistant Inspector General and the Inspector General agreed. Nonetheless, the OIGB subsequently approved the preliminary and final prospectuses. No disclosure was made in them of the OIGB rating.

7. Events Leading to the Call for Government Support

The combination of the bank's failure to make specific provisions for bad loans in its financial statements although clearly indicated in many loan files, the inclusion in the statement of income of uncollected interest, the use of future evaluation techniques in assessing the worth of security, and the repeated assertion by management that the California energy loans had suddenly collapsed, may have masked the real problems in the bank so that they were not appreciated by the regulators and the major banks when McLaughlan approached the Inspector General and the Bank of Canada for assistance. These problems were compounded by a communication breakdown at the top of CCB management. The Chairman of the Audit Committee, Mr. Hillman, himself an auditor, went to Los Angeles on about 11 February and met with officers of Westlands and the Los Angeles Agency of the CCB. He was acquainted with certain problems in the United States operations. He expressly denied seeing the FRB report on the Los Angeles Agency dated on or about 6 February, but he did examine and discuss in Los Angeles the letter from the FRB bearing that date which forwarded the report to the Agency. According to notes, this letter commented upon the quality of the Agency's assets. According to his testimony, Hillman brought the covering letter from the FRB back to Edmonton but he did not bring back the report. He offered no explanation as to why he did not examine the FRB report or why he did not obtain the reaction of the Los Angeles executives to it. He was of course aware of the concurrent merger of REIT with CCB scheduled to close on 18 February, and that much information on CCB was required to be filed with the provincial securities commissions in that connection. He did not report all this to McLaughlan from Los Angeles nor did he do so immediately upon his return to Canada, preferring, as he put it, to let matters proceed through "proper channels". The Heisz report on the California energy loans, telephoned to McLaughlan on 23 February, may not have been ready for delivery on 13 February in Los Angeles to Hillman, but it is a reasonable inference that the discussions between Hillman and Heisz about the quality of loans in the Agency must have included some reference to these energy loans which within 10 days were said to be so critical as to put the survival of the bank in doubt.

As described in Appendix D, the FRB called the Inspector General about their report early in February 1985 and again on 20 February. The FRB reported that the Los Angeles Agency was faced with "staggering losses" which raised concerns not only for the welfare of the Agency but for the whole bank. Between these calls the Inspector General had spoken to McLaughlan and had received reassurances about the state of affairs in California. McLaughlan, according to the Inspector General's recollection, reminded him of the over-reaction typical of United States regulators and stated the workout programs in California "were going well". It says little for management communication that within three days of receipt from the senior staff in Los Angeles of a calamitous report on that branch's loan portfolio, the CEO of the bank was still able to report that things in California were "going well". The Inspector General thereupon advised the FRB that he was satisfied with the bank's management and the solutions which were in hand and that, in any event, all this would be reviewed with the bank at a meeting already scheduled for 14 March 1985. The CCB reassurances based on detailed loan review in contrast to the FRB's "broadbrush approach" and the age of the FRB assessment, it was said, supported the Inspector General's view of the 20 February information: "It was not a matter of the greatest urgency and it was never regarded by us as being a matter that would bring down the bank."

It may be of some significance that CCB did not forward to the OIGB the FRB report which it had received from Los Angeles between the 6th and 11th of February until 7 March, although the Inspector General specifically requested it on 21 February after the FRB's second phone call. As has already been seen, the Inspector General saw nothing in all this which threatened the bank's future. He thought it could not be so serious as the United States authority had spent much time drafting its report: from October 1984 when the inspection was made, to February 1985 when the report was released. The Inspector General thereupon went on vacation leaving the meeting of 14 March to his staff. In fairness to the Inspector General, it should be pointed out that neither McLaughlan nor anyone on the CCB staff had communicated to the OIGB anything about additions to the agenda of the scheduled meeting for 14 March. In the last communication on this subject, Grant recorded that McLaughlan had advised him that the bank proposed to discuss a "few points including: (a) strategic plan for 1985 and beyond; (b) the next phase of the capital plan; (c) review status of various other matters including U.S. operations."

By 8 March, as detailed in Appendix D, the Bank of Canada had received full information about the OIGB's concerns regarding the condition of CCB. A Bank of Canada memorandum outlining the OIGB's position states that the Assistant Inspector General "intends to probe into the bank's medium term plans and to question his visitors about the measures they contemplate to redress the situation". With reference to a possible share issue, the memorandum further states:

> The CCB could, in turn, use the proceeds from the share issue to cushion the impact of the sale (at a substantial discount) of the doubtful loan portfolio to an arm's length third party.

From this documentation and Grant's memo of 6 March, it is clear that the seriousness of CCB's condition was recognized by the OIGB and by Bank of Canada staff prior to the McLaughlan presentation of 14 March. The Bank of Canada involvement in this inspectional matter was not explained.

The Inspector General and the bank management share at least one position in all this: each claimed, until after 25 March when the support program was announced, that the sudden fall of the bank was not foreseeable at least until late February or early March and that it was due to the sudden drop in the value of California energy loans which the bank management attributed to a drop in the OPEC oil price of $1.00 per barrel.

There was apparently no close liaison between the United States and Canadian regulators or a sharing of their written reports. McLaughlan by design or accident got in between the two regulators and at least delayed the realization in Ottawa that serious troubles were upon CCB. The Canadian regulators even in February did not appreciate the deadly significance to CCB of the transfer of all the Los Angeles Agency's bad loans to the Canadian head office and the transfer of the good loans to Westlands from the Los Angeles Agency. All this was done for the stated purpose of placing Westlands in a position to benefit from its eligibility to make tax loss carry forward. This process turns out to have saved what was originally to have been CCB's lifeboat but sank the mother ship in the process. Since the Los Angeles Agency represented, according to the Inspector General, 10 to 12 per cent of CCB, the calmness of the Canadian regulator in the face of the United States regulator's report is remarkable.

B. THE CCB SUPPORT PROGRAM

The origins and fate of the plan to rescue CCB are important not so much on the issue of the cause of the bank's failure but because the whole process throws light upon the bank regulatory structure and its participants at that time. They also reveal some basic considerations which must be applied to the determination whether the public interest is served by a bank rescue mission involving public funds, should such a rescue ever again become necessary in this nation.

1. Events Leading to the Adoption of the Support Program

The process leading to the CCB Support Program started with a sudden unannounced presentation by McLaughlan in Ottawa to officials of the OIGB on 14 March 1985 of the need for help. In the absence of the Inspector General, Mr. D.M. Macpherson, the Assistant Inspector General, acted in his place. McLaughlan repeated his exposé later before the Governor of the Bank of Canada and some of his staff. McLaughlan stated that the bank could not survive unless "massive assistance" was provided. Following a report on the background to the situation in which he indicated that the problems were precipitated by the recent severe drop in the value of the bank's California energy loans, McLaughlan proposed four alternative solutions for consideration. McLaughlan and his staff then made arrangements with the Bank of Canada for interim liquidity support. No one apparently faced up fully to the fact at that time that the issue was not liquidity but solvency.

McLaughlan, having delivered his startling message, left Ottawa for Edmonton, and although the reasons for so doing are not clear perhaps it was to prepare for an adjourned board meeting which was to resume on 19 March. At this point no program had been laid out for a systematic reaction to the CCB situation as revealed by its officers. The Governor of the Bank of Canada, however, showed an awareness of an urgent need for action, because the next quarterly results would soon be available and meetings had already been scheduled by CCB with significant United States depositors.

On Friday, 15 March, the OIGB informed the Minister of State (Finance) about the situation as then understood. The Minister revealed no preference to save or liquidate the bank. On the same day the CDIC Board met. Governor Bouey "strongly argued for saving the bank". The Deputy Minister of Finance agreed so long as Government funds were not committed. In the meantime Macpherson determined from the Royal Bank of Canada that a merger was of no interest to them except as a vehicle for liquidation of CCB. By Saturday, 16 March, both Bouey and Macpherson wanted to involve the major banks. However, the Minister of State (Finance) decided to confine disclosure of the CCB crisis to the Royal Bank for the moment. On Sunday, 17 March, Macpherson advised McLaughlan by telephone that liquidation was a likely course to be taken. McLaughlan was surprised at this revelation and immediately set about with the help of his Comptroller to develop the first version of the rescue program. This provided a general format which became the Support Program that was finally adopted, except in the opening version neither federal funds (other than the CDIC contribution) nor monies from the six major banks would be involved. This idea interested Macpherson who the next day (Monday) advised the Minister of State (Finance), sent Grant to Edmonton to examine the nonperforming loans of CCB and to review estimated loan losses, and summoned McLaughlan back to Ottawa.

At this time there was no assertion of leadership by the Government or any of its agencies in reaction to the bank's crisis. The Government of Canada was weighing the costs of abandoning its general policy of nonintervention by the state in matters of the marketplace against the consequences to CCB's depositors and investors should the bank fail. The Deputy Minister of Finance recognized that "a bailout was inimical to that philosophy ..." but at the same time he saw the strong possibility of the tidal wave effect that a CCB failure would have upon the bank's creditors and small financial institutions across Western Canada. The proposed rescue plan then under review was a desperately contrived creation prepared without time for reference to the bank's Board, other members of senior management and auditors or lawyers. Nor was the proposed plan subjected to an immediate critical analysis by the combined forces of the OIGB, the Bank of Canada, the CDIC, the Department of Finance and their respective legal and accounting advisors. The Federal Government neither accepted nor authoritatively rejected committing public funds. Nor did the Government decide to bring in immediately experienced representatives from the major banks to survey the problem and to share the burden.

On Thursday, 21 March Governor Bouey invited the Chief Executive Officers of the major banks to a meeting in Ottawa to be held the next day. This was one week after McLaughlan's confession of the problem. The representatives of the Government of Canada came to this meeting without any decision having been made as to whether to contribute public funds to the rescue of the CCB. In the meantime, commencing at least on 19 March and certainly by the morning of 22 March, McLaughlan, Macpherson and Mackness (of the Department of Finance) had received inquiries from people in the financial markets regarding rumours of trouble in CCB. Given the sensitivity of banks to the loss of public confidence and the proclivity of depositors, particularly those from the wholesale money market, to "fly to safety", an immediate decision by the Government on the course to be taken was forced.

On 21 March (Thursday), the two Ministers met with the Deputy Minister, Governor Bouey, and the Inspector General (who had returned to Ottawa the day before). The participants "tentatively" decided to attempt to save the bank by implementing the plan originated by McLaughlan which was relayed to the meeting by a memorandum from Macpherson. Under this plan CDIC would purchase all the loan loss provisions ($244M) which CCB now acknowledged must be set up. The $244M would be repaid by granting CDIC a participation in 50 per cent of the bank's profits. The bank estimated the pay-back period would be 15 years. The plan was to be made attractive to CDIC by a grant of warrants to purchase five million shares of the bank at $5 per share which, at year end 1984, had a book value of $18.50 per share. All dividends on common and preferred shares were in the meantime to be suspended until the $244M had been repaid.

This version of the rescue plan, like those advanced thereafter, referred to "a purchase" of loan loss provisions or an interest therein. This is a significant misdescription because the plan also provided for "repayment of the purchase price", hardly a characteristic of a purchase and sale. If the plan was a "sale" of the interest in specified loans which had been written off or written down, then the $255M (the final figure used in the Program) on the CCB books would have been an asset and could perhaps be treated for both taxation and banking purposes as capital. Further difficulties, however, flow from the eventual failure to classify the moneys to be advanced by the support group to CCB.

Nothing was said in this early version of the plan about the position of collections on these loans of either interest or principal. Nothing was said as to the nature of the $244M in law or accounting, once it reached the accounts of the CCB. Nothing was said in this embryonic form of the support plan about the term or life of the warrants to be issued to CDIC in compensation for the use of its monies. It is understandable that McLaughlan's first draft did not go into details. He was unable to presume that the Government of Canada would invest public funds in a rescue program and he could not appear to assume that his competitors, the major banks, would do so either.

The CDIC tentatively approved this generalized plan on the morning of 21 March, and agreed to participate in the plan to a limit of $75M conditional upon the participation of the chartered banks and the Province of Alberta. The resolution of the Board of Directors contained the proviso that CCB's estimated loan losses be "confirmed by examinations currently in progress" by the Inspector General's representatives. There were other provisos not here relevant.

In the meantime, McLaughlan had prepared another version of this plan dated 20 March for a representative of the Bank of Canada and for Macpherson, in which it was stated that $244M was a payment in purchase of "the aggregate loan losses" and a profit participation in CCB to the extent of $244M less collections on the loans included in the Support Package.

After CDIC approval of its participation in the tentative plan, the Governor of the Bank of Canada on the afternoon of 21 March invited the Chief Executive Officers of the six major banks to a meeting at the Bank of Canada for the next day, Friday, 22 March 1985.

Serious problems had accumulated in the week since McLaughlan's visit to Ottawa on 14 March.

1. No decision had been made by the public authorities to save the bank or to let it go into liquidation.

2. Information then in the hands of the regulators was not adequate either to verify or deny the described state of the bank's loan portfolio as described by McLaughlan on his visit.

3. The financial community's awareness of a crisis was forcing a decision.

4. The bank's proposal for its rescue had been hastily prepared and had not been advanced by this time to an acceptable or workable plan by the public agencies thus far involved.

5. No decision had been made as to availability of public funds to any rescue program which might be undertaken.

The meeting on 22 March was attended by the Governor and the Deputy Governor of the Bank of Canada, the Inspector General, the Deputy Minister of Finance and the Chief Executive Officers or Presidents of the six largest Canadian banks. The Chairman of CDIC was not called to the meeting, although earlier in the week the CDIC had prepared studies of the cost of liquidation of the bank as compared to the cost of running off its affairs in an orderly way over a period of time. Some 20 persons were in attendance at the meeting. All present apparently assumed the Governor of the Bank of Canada should lead the way and preside in these affairs, although the Bank of Canada had almost no role or statutory function to play in the liquidation of an insolvent bank. Bouey stated in this Inquiry, and in the Committees of Parliament, that before these events took place many people perceived the Governor of the Bank of Canada to be something like "the czar" of Canadian banking. But he soon came to appreciate fully that the Bank of Canada was not a main actor in these matters.

The chairman of the meeting, Governor Bouey, made it clear in opening that the question faced by the meeting was one of solvency and not liquidity. The Inspector General related what McLaughlan had told the OIGB and the Bank of Canada concerning the cause of the crisis, that is, the imminent $85M write-off necessary on the United States energy loans, which, coupled with losses suffered in Canada, would eliminate the bank's capital. He reported on these and other problems in the loan portfolio and indicated that the bank had recently been examined by his own representatives. This examination related to loans in both the Canadian and United States divisions of CCB identified in a preliminary way by the bank as being part of the proposed support package. The Inspector General relayed the essence of the report on this first loan examination to the 22 March meeting and said that the results revealed possible additional loan losses in the range of $60M but that on the whole the assessment of the loan loss situation by the President of CCB was confirmed. The bankers were concerned about the state of the CCB loan portfolio. Allan Taylor, President of the Royal Bank, questioned the Inspector General about CCB's estimate of the losses and asked whether CCB's figures were "exceptionally conservative". The Inspector General's reply was "yes". This may reveal a failure in the regulator to appreciate fully the key importance of the precise state of the loan portfolio to the fate of the bank; which in turn might reveal the almost subconscious acceptance by the OIGB of the auditors' unqualified certificate on the financial statements as a general guarantee that "all's well". Apart altogether from the result of the auditors' certificate, the facts before the Commission are that at each year end the auditors pointed out to the bank and to the OIGB that management should be "more conservative". This was, of course, unknown to the bankers present.

An analysis of the work done by this first inspection team sent out by the OIGB (the first of four inspections performed by bankers and operated by the OIGB) reveals quite a different situation. In fact the assessment of the loan losses on 21 March 1984 was that as much as $68M in additional provisions should be taken on the Canadian division loans along with a further $20M on the United States division loans. Grant had unilaterally reduced this Canadian assessment by about $7M, and it is unclear on the evidence whether this fact or the United States results ever reached the OIGB in Ottawa during the deliberations. Further, in the time available for the first inspection only a very small sample of the loans that were eventually included in the Support Program could be examined in detail. It is difficult to understand how the regulators and indeed the representatives of the major banks and the Bank of Canada would wish to proceed into a detailed rescue program on the basis of an assessment of such a tiny fragment of the bank's loan assets. All present at the meeting on 22 March did agree to one thing. Because of the growing public awareness of the bank's problems, a solution had to be found that very weekend. Otherwise, the only alternative was to close the bank down and not allow it to reopen the next Monday. This forced a preliminary decision as to whether the information at hand was adequate.

McLaughlan joined the meeting and described the present condition of the bank. The essence of the remedy he sought was a support program to provide the bank with about $244M to replace the total of the write-offs occasioned by the energy loan losses which were seen as imminent and the write-offs which the bank claimed would necessarily be suffered on the treatment of other problem loans in a plan to accelerate the bank's return to profitability. The total principal value of the loans in question was about $520M. The capital of the bank at that time approximated $130M so that it was evident on the most superficial examination of the problem that failing the infusion of these monies the bank would be hopelessly insolvent. The discussions in this opening session started a long series of misunderstandings that continued through to the last days of the bank and indeed into these hearings. The OIGB staff, the Presidents and Chief Executive Officers, and the Bank of Canada's staff appear to have understood the support plan as meaning that the bank would, after receiving the $244M, liquidate the portion of the loans in the group of loans comprising the support plan retained by the bank, and thereby replace the lost principal and restore the loss of earnings these loans represented. McLaughlan's memoranda of 20 March to the OIGB and to the Bank of Canada appear to describe such a program and would not reasonably be understood as allowing the bank to accept the $244M from the parties to the rescue, and then gradually liquidate some of the loans, quickly liquidate others, and write off portions of others so as to restore their interest return to market rates. In short, the parties to the program expected the bank to liquidate its retained interest in the Support Package loans whereas the bank expected to retain some of these interests during a period of slow collection and to retain others as loans performing at market rates of interest. This was but one misunderstanding. Notwithstanding McLaughlan's attempts during and after the weekend of 22-24 March to clarify the terms of the proposed support program, the terms remained ambiguous. The points for which McLaughlan contended would have produced a rescue plan a little more likely to succeed. The structure of the meetings had this unhappy result.

McLaughlan left before any decision was reached. He returned immediately to Edmonton, presumably to arrange for the approval by the Board of any settlement which might be reached and perhaps also, although it is not clear, to endeavour to obtain agreement of the debenture holders to the subordination of the outstanding debentures to the support plan. The major banks retired and came back with a counter-proposal. They were prepared to participate in a total program of $255M of which $75M would be provided by the CDIC from funds of which the banks were substantial contributors. The remaining $180M would be divided equally between the Government of Canada, the Province of Alberta and the six major banks. All of this was subject to the debenture holders accepting subordination to the advances by the parties to the rescue program.

Through all these and subsequent discussions was a request and eventually the assumption that the Inspector General would examine the entire CCB loan portfolio. To this end the bankers agreed to provide a cadre of qualified bank credit officers who would conduct at the Edmonton Head Office an examination of the bank's loans under the general coordination of Grant. It was never made clear whether this examination was to be limited to loans comprising the Support Package or was to cover the whole of the loan portfolio outside the Support Package. More importantly it was not clear whether it was to be completed that very weekend, later during negotiations, or during the performance of any support program which might be adopted by the meeting. The discussions and arrangements surrounding the examination of the bank's loans left a great deal to be desired and it is difficult to comprehend how experienced bankers and the staff of the OIGB could have allowed this issue to remain unresolved through all these meetings and two written agreements. It remained unresolved until at least the first week in July. Some would say on the evidence before the Inquiry that the question was never squarely addressed, and the examination was never completed.

Notwithstanding this glaring omission in the gathering of information vital to the design and launching of any rescue of the CCB, such a plan was undertaken. All this is even more remarkable when one remembers that, faced with similar bank collapses, the banking regulatory authorities in the United Kingdom and the United States, shortly before the CCB episode, responded with precise plans which included a detailed assessment of the true value of the assets of the failed banks and some objective assessment of the reason for failure. In both cases the latter assessment resulted in the immediate replacement of management and the later cancellation of all outstanding shares of the banks which were facing liquidation.

Clearly, the design and scope of the Support Program turned on the condition of the bank's loan assets. If the $244M estimated by McLaughlan was badly in error, the plan could not succeed. It is not unexpected, therefore, that someone, in this case the Inspector General, would believe that the participants, the banks and Government agencies alike, would require examination of the loans identified by McLaughlan as requiring write-downs to determine whether his assessment of the write-down would be sufficient to restore those loans (and indeed the loan portfolio) to appropriate values. It is equally evident that the rescue program would be a futile exercise if the Support Package loans were only part of the burdensome loans in a total portfolio of some $2.3B. It is not therefore unexpected that Allan Taylor, among others, would, throughout the meeting and periodically thereafter, seek an assurance from qualified bank credit officers that the balance of the bank's loans were producing earnings and were not impairing the bank's capital. What is surprising, however, is that no term requiring an examination of CCB's loan portfolio is to be found in either the initial Memorandum of Intent of 25 March 1985 or the final Participation Agreement of 29 April 1985. Eventually, after the banks had raised the issue with the Inspector General and with the Ministers, a more comprehensive review was undertaken at the instigation of the Minister of Finance by bankers of long experience in some of the major banks but who, at the time of their examination of the CCB loans, were in retirement. A complete examination of all the loans in the bank, however, was never carried out. The Inspector General had an explanation for the failure to pursue a loan examination immediately after the rescue program was constructed. He said that after the Bank of Canada and the Minister of State (Finance) had announced on 25 March that the bank was in a sound condition and solvent, it would appear strange to see these same authorities ordering an independent examination of the bank's principal assets.

2. Inspections of CCB's Loan Portfolio

The inspections which were made require some comment. There was a lack of communication through the OIGB of the results of loan examinations at CCB by the Inspector General's staff and representatives appointed by the Inspector General from the staffs of the major banks. As already seen, the assessment completed on 21 March, as reported to the meeting on 22 March, did not reveal a unilateral reduction by the OIGB of $7M from the additional losses proposed by the bank credit officer who performed the examinations of the Canadian division loans. Grant, under whose direction the examination was made, apparently struck a compromise between the bank's assessment of the loss and that of Tallman, the banker made available to the Inspector General by the Royal Bank. Grant himself did not examine the loans and had no experience in such work. Nor apparently were the results of the United States inspection reported to the OIGB in Ottawa, or by the Inspector General to the bankers at the 22 March meeting. This overlooked another $20M in loss provisions.

The second inspection on 24 March was incomplete and its results were inaccurately relayed to the meeting. The divergence between McLaughlan's description of the loan losses as identified by management and those assessed by the bank examiners was of a magnitude which would suggest that the meeting, if fully apprised of these facts, would not have proceeded with the Support Program as proposed, or perhaps with any plan.

Beginning in July, George Hitchman, a retired Deputy Chairman of the Bank of Nova Scotia, led a team of retired bankers who examined, in July and August 1985, loans having a principal or face value of some $423M. From this partial examination Hitchman and his colleagues calculated by projection, losses reasonably to be encountered by CCB of some $900M to $1B. It would be readily seen that if only one-tenth of these additional write-offs were actually required to be taken by the bank it was insolvent and beyond redemption by the designed bailout program.

The failure to conduct a timely and effective examination of the loan portfolio was a serious flaw in both the planning and the execution of the program. On the other hand it must be appreciated that according to Hitchman and others a complete assessment of the CCB loans would require several weeks with a large staff of experienced credit officers. This strongly suggests that the procedure adopted by all the parties to the program was seriously inadequate. This in turn would indicate that at least two more phases in the rescue scheme should have been planned so as to allow a retuning of the scheme or its abandonment depending upon the results of the examination of the loan assets. Instead, the incomplete, if not clumsy, Support Program was simply left to function on its own.

3. Flaws in the Support Program

As it turned out, realizations estimated by CCB on the Support Package loans, instead of being at the planned 50 per cent rate, were 30 to 35 per cent only, and CCB, whatever its plans under the original proposal, was immediately unable to assemble capital and to report the earnings which would enable it to survive. More seriously, the lack of precision in defining the nature of the monies infused into the bank by the program caused a further failure in earnings, which in the end produced a complete lack of confidence in the bank by the professional deposit market. The CCB was left completely dependent upon the Bank of Canada for deposits. The Bank of Canada in turn was left solely dependent for its security on a loan portfolio having an unknown true worth, but which was considerably smaller than the value at which the loans were carried in the financial statements of the bank.

The plan had a number of apparent flaws. These are related and analyzed in order to determine the nature of a rescue program appropriate for a bank whose solvency is threatened.

a. Adequacy of the Support Package

The evidence raises considerable doubt as to whether the Support Package was anywhere near adequate. By one test, too simple perhaps, anything less than $500M paid in as quasi-capital would not have sufficed. The bank, according to the evidence of the liquidator, was losing during the 1985 fiscal period about $5M a month. To replace this, the bank would have had to create sound loans which would produce in the order of $50M to $60M of net income a year. If the $500M was paid in without obligation to reduce liquidity advances or other liabilities, the bank would have had the funds necessary for the making of loans sufficient to produce, in theory, the missing income. The first and second assessments of the bank's portfolio by bankers representing the OIGB indicated at least $116M additional loan losses were to be encountered. The third assessment revealed additional losses of at least $57M on the support package assets alone. Some loans included in this group may overlap with loans reviewed in the earlier inspections. The fourth assessment would indicate that a rescue program was not a viable alternative. The bank perhaps had submerged so far below the level of solvency that it could not practically be revived. It is surprising that the "rescue" moneys of $255M were simply paid through the CCB to the Bank of Canada in reduction of liquidity advances. At least the bank might have been able to lend the money out and presumably achieve an interest spread which would contribute earnings to the bank in its hour of need. The favourable Bank of Canada lending rates would have made it easier for the bank to produce such net earnings from the support group moneys. Simply reducing the debt by the bank to the Bank of Canada does not constitute a successful rescue program. Neither can this payment be applied in justification of any opinion that the bank was solvent after the rescue program was implemented on 25 March. The $255M reduced the bank's debt to the Bank of Canada, but itself became an obligation to be retired by collections on the Support Package loans or on liquidation, out of the assets of the bankrupt bank. The receipt of the $255M therefore is irrelevant to the presence or absence of solvency. Whatever state the bank was in at that time remained unaffected by the receipt of the Support Package moneys. The Inspector General, therefore, was in error in finding the bank to be solvent upon receipt of the $255M. It should be borne in mind that the $255M, by the terms of the interim and final agreements, remains an obligation in debt of the CCB. While the reduction of the Bank of Canada debt would improve earnings, the receipt of the moneys from the support group under the circumstances created by the agreements would, contrary to the Inspector General's letter, have no impact on the issue of solvency. The monthly losses being incurred by the bank made it very unlikely that any accumulated earnings might result which would influence the solvency test.

b. Treatment of Income from Support Package Loans

McLaughlan interpreted his designed rescue plan as enabling CCB to collect and record as interest the moneys received on the loans written down in the Support Package. The major banks took the opposite view; that all receipts on the loans would be applied first to principal in accordance with applicable OIGB guidelines and were to be applied in repayment to the participants. This was a part of the largely undocumented understanding accepted informally in connection with the major banks' counter-proposal on 22 March 1985. McLaughlan was not present, and therefore no negotiation in any sense of that term took place from that time forward to the execution of the final agreement on 29 April 1985.

The impact of this provision on the bank was serious. It could not show earnings if it received no interest income from the Support Package loans and/or loans brought into being by means of the new funds advanced to the bank. Without earnings the bank could not attract deposits; without deposits the bank could not remain in business. There is also evidence that the inability to earn income on some of the loans forced a quicker liquidation of those loans with consequent losses greater than projected by CCB.

It is understandable that the one rescued would have little or no bargaining position with the rescuer in working out relative obligations under the plan. On the other hand the rescuers must have been aware of the complete impracticality of a rescue program which would leave the bank without income during the process. In all probability, however, this was not a serious contributing factor in the bank's failure, largely because the collapse came so soon after the introduction of the Support Program and can be ascribed to a combination of many other causes.

c. Warrants

The warrants to be issued to the big banks (in the initial plan, to the CDIC) in the view of CCB management had the effect of closing the equity markets to CCB for "20 to 25 years". The price of the warrants descended from $3 per share in McLaughlan's first draft to 25¢ per share in the final agreement. The period for exercise of the warrants extended from 5 to 10 years before the agreement was signed. The effect of the warrants was, as Chairman Paine testified, to destroy the existing shareholders, and he went on to characterize the terms demanded on the warrants as outrageous.

The warrants raise a serious problem. Without some potential reward for advancing a considerable sum of money under rather risky circumstances, the plan might well have been regarded by the major banks' own shareholders as improvident. Why should a bank come to the aid of shareholders of its competitor? Almost axiomatically, by the time this, or perhaps any, rescue program was adopted the bank was insolvent or on the brink of insolvency. Hence, the bank's shareholders had lost their investment. On the other hand, one must wonder about the fundamental aims, if not the morality, of transferring the warrant concept from McLaughlan's first plan, wherein the warrants were to be issued to a public institution, the CDIC, for their eventual disposal (presumably in the private sector) upon the refurbishing and reorganizing of the bank, to a situation where the warrants were to be issued to competitors. The competitor bank would perforce sell these shares on the market since the *Bank Act* forbids the retention of more than a 10 per cent interest by any single shareholder and completely forbids a bank from holding shares in a competitor.

In the different approaches taken to recent problem banks, upon recognition of insolvency by the Bank of England and the FDIC in the United States, the shareholders were immediately closed out by one device or another. Here there may have been some difficulty, in view of the approach taken by the Inspector General and the Bank of Canada, to demonstrate conclusively the insolvency of the bank and therefore the loss of all value of outstanding shares. That being so, the path of least resistance was the device of warrants even if they were issued to CCB's competitors. If the end purpose of the rescue program was to bring about the continued existence of the CCB as an independent Schedule A bank, it is difficult to see how these warrants were to achieve that purpose except in the circumstance that all the banks agreed on a time and method of sale of the warrants to purchasers qualified under the *Bank Act*.

A rescue program by definition is undertaken when insolvency is present or is considered imminent and inevitable. By definition, insolvency means the shareholders have lost all their investment. Thus before public or indeed private funds are placed in such a bank in order to keep it in business, the outstanding shares should be cancelled or transferred to the rescuers or a trustee for retention for reissue when propitious; subject no doubt to a right in those shareholders under the plan to join the rescuers with new capital on the same basis.

The plan here, probably of necessity and having regard to the paucity of precise information on asset worth and the very short time available for action, omitted any direct action concerning the shareholders' position and included only a tool for use at a later time to virtually erase these interests. This method had the added advantage of avoiding the prohibition in the *Bank Act* on banks' acquisition of shares in a competitor. Furthermore, the CDIC may not have had the capacity in law to acquire the shares of CCB, perhaps even as a trustee.

d. *Priorities on Insolvency*

The character in law of the $255M payment, left as it was in an uncertain state in the description in the rescue plan, raised still another problem. The banks considered that their respective share of the $60M contribution should rank in the same way as a depositor's moneys in the bank in the event of insolvency. As McLaughlan was quick to point out, such an arrangement would have to be reflected on the balance sheet of CCB and the marketplace would reflect long and hard before risking any further deposits with a bank facing such a large claim ranking at least equally with the depositors on liquidation. The Support Package should have classified these moneys as an unrecoverable purchase price, as a capital grant of some nature or as a subordinated loan, repayable out of earnings only. What CCB needed at this time of crisis was a loan without recourse in the nature of a capital grant repayable only from future profits and not a loan which would retain that characteristic and revive when the bank ran into further difficulties. Taylor, speaking only for himself, agreed to the merits of this complaint and agreed to reconsider the issue if it turned out to affect adversely CCB's deposit-taking activity.

e. *Relations with the Major Banks*

It is strange that the Memorandum of Intent and the Participation Agreement made no reference to the continuation of existing interbank credit arrangements between CCB and the major banks. The banks, from their viewpoint, quite reasonably interpreted the Support Package as being a complete articulation of the obligations of the major banks. This is supported by the fact that their contributions, unlike those of the Bank of Canada, did not result in prior security rights under the *Bank Act*. The fact is that the major banks withdrew their support or failed to renew it as the arrangements expired, despite the pleas of the Governor of the Bank of Canada. The effect of this withdrawal of support was said by some who appeared before the Commission to reflect seriously on CCB's future in the money market. Potential depositors, particularly those outside Canada, were quick to appreciate that the major Canadian banks were no longer staying with the arrangements made with CCB prior to the inauguration of the Support Program. Because this issue, along with many other issues surrounding these events, might come before other forums in the future, further comment upon this matter is not appropriate. There is no clear evidence that this omission from the plan made any significant contribution to the failure of the Support Program.

f. Noninvolvement of the CDIC

The CDIC more than any other federal agency had experience in recent times with the liquidation of financial institutions which came under federal regulatory supervision. However, this agency was only indirectly involved in the negotiations or, more accurately, the deliberations which led to the construction of the rescue plan. The serious defects noted above might well have been pointed out "by those experienced in liquidation" and hence it might have been considered as a flaw in the arrangement not to have formally or thoroughly involved that agency in the formation and execution of the plan.

g. Failure to Replace Management

A rescue plan, by definition, must aim first to restore confidence in and the earnings of the bank. New capital will achieve the second goal, while the first, on the evidence here, required a change of management. The market could not expect improvement from the team which presumptively caused the trouble in the first place. Such was the testimony before the Commission and the experience in the United Kingdom and the United States. That does not conclusively pass judgment on management. It is simply said to be a fact of life in the market.

h. Inspections

As discussed earlier, during the Support Program negotiations and the performance of the plan, the OIGB arranged for four inspections or examinations of the bank's loan portfolio. The first two involved active bankers with loan credit experience in the major Canadian banks. A third inspection took place as a by-product of the work of the special representatives appointed under the Participation Agreement. The last team retained or appointed by the Inspector General for this purpose was made up of retired bankers who again had worked as bank credit officers in the loan granting processes of the major banks.

These inspections produced examination reports which had one thing in common. All found that the loan portfolio was seriously overvalued on the balance sheet and therefore extensive specific provisions would be necessary on many of the loans examined. These reports related to both loans included in the Support Program and loans outside that package. There were elements of confusion surrounding all these inspections:

1. The first two inspections were hastily put together and the first two teams were not certain as to what loans they were examining.
2. All teams were uncertain as to precisely the object of the examination. It was unclear as to what aspects of the loans were of interest to the Inspector General. For example, it was not made clear whether the reports were to reclassify the loans according to the valuation method of the examiner, whether the specific provisions were to be weighed and adjusted, and whether the decisions taken by CCB management regarding capitalization of interest and fee income were to be assessed.
3. In some instances the reports made to the Inspector General, to the bailout meeting, and to the Minister of State (Finance) were not made in writing and, at least in the case of the first two examinations, were apparently not fully and accurately communicated.
4. Extensive capitalization of interest was reported in June by one examiner, apparently doing so on his own initiative, but was not brought to the attention of the bailout participants, and there was no immediate reaction from the regulators.
5. As discussed earlier, OIGB staff, during the first examination, reduced the provisions recommended by one independent expert examiner. This occurred during the meetings of the support group participants undertaken to determine whether the bank should be rescued. On the evidence, this was never reported to the meeting. In another instance, during the third inspection, an examiner's recommended provisions of $50M were reduced by $17M. The OIGB and the bank then agreed that the remaining $33M need not be taken at once even though the examiner felt they were required immediately. OIGB staff instigated these negotiations. None of this was apparently reported to the support group participants.

Other inspections or examinations of the bank were made following formation of the Support Package. A Schedule B bank interested in a possible merger examined CCB and reported to the Minister of Finance that he "had a dead bank on his hands". Garth MacGirr, the liquidator appointed by the Court of Queen's Bench of Alberta, in his testimony to the Commission stated that many loans were grossly underprovisioned, that is, overvalued in the balance sheet, and that realizations on the Support Package loans would be well below anything anticipated by CCB management when they proposed their rescue plan.

In the result, the information available to the participants in the rescue program clearly showed that even after the unilateral reductions in proposed specific provisions by the OIGB, even if the Hitchman Report of losses was grossly overstated, and even if the results of the examinations were too broadly extrapolated across the total loan portfolio, the capital of the bank had disappeared. Not one of these experienced bankers reached any different conclusion than that the loan portfolio was greatly overvalued in the financial statements of the bank. At the very latest, by 1 August 1985, the only question which remained unanswered was how long had this bank been disguising itself as a solvent bank.

The trouble surrounding the rescue is illuminated by the comments of one of the special examiners, J.R. Johnston, and the Inspector General's reaction thereto. His reports to the Inspector General on the 7th and 24th of June contain comments relevant to an assessment of the bailout program itself:

1. There was little evidence that the policies which had gotten the bank into trouble in the first place had been changed; and

2. It was important to look at the rest of the loan portfolio, that is, the loans outside the Support Program.

It is not known if any participants in the Support Program other than the Inspector General ever saw these reports. It is known, however, that the major banks had been pressing throughout the negotiations and down to at least the middle of June, for an examination of the balance of CCB's loan portfolio. It was not until mid-August that the Inspector General received anything like a comprehensive report on the state of the bank's loan assets.

4. The Hitchman Report

This was the major portfolio examination. Management of the CCB accepted many of the specific provisions proposed by this examination and those made earlier. Management criticized other proposed write-downs as being based on practices by the big six banks which were not practiced in the small banks. Management also criticized the inspection process itself: the examinations were hurried; many errors were made by the examiners in their calculations; they did not look at the branch files in many cases but relied only on the summary head office files; the valuations of the loans and the security held by the bank were made on a liquidation, not a going-concern, basis; and the extrapolation of the results obtained from the Hitchman team examinations of 84 loans in order to quantify the specific provisions required on the entire loan portfolio, was unreasonable.

The Inspector General's instructions to the Hitchman team were to value loans on a going concern and not on a liquidation basis. Hitchman himself testified "... we are not thinking of reports on a liquidation. We are making up a common sense appraisal to determine what is a potential loss on that account on an ongoing basis." The issue whether Hitchman's extrapolation was reasonable does not require resolution because his overall conclusion that the bank was insolvent is correct. The extension of a sample to describe the whole must frequently be a risky proposition. Hitchman said an examination of all the loans would require 20 or 30 examiners working over a period of two or three months. It appears to be a reasonable approach to do as he did. It is also reasonable to factor downwards all the variables so as to be conservative. Indeed Hitchman invites the reader to conclude that CCB required loan loss provisions of $900M to $1B "or some reasonable percentage of such figures". There is beyond any reasonable debate a considerable data base in support of the Hitchman conclusions. One of his team reported, for example, about Halifax:

> If the quality of the loans at all branches follows the Halifax pattern, the possibility of the bank survival seems remote, simply because their nonrevenue percentage and ultimate write-off will be enormous in terms of their present asset base. It may be that the Halifax loans are not indicative of the standard of other branches, but the few Edmonton-based loans examined by us also include unsatisfactory risks which we assess below the ratings presently applicable to CCB.

It is significant to note that the Hitchman report also reviewed bank-generated internal reports showing that about $722M in loans (about one-third of the total portfolio) were marginal and unsatisfactory loans, about half a billion of which were nonearning. He predicted, accurately, that there will be "very substantial losses in 1985".

The regulators could not simply overlook this report. The scale of the recovery program clearly did not match the size of the wreckage. Too late came the recommendation by Hitchman (which Korthals had mentioned during the crucial meetings of 22-24 March) that the Board and the management of CCB must be reviewed. Because there was no ongoing machinery to implement and oversee the Support Program, Hitchman's report did not reach the participants. The Minister of State (Finance), who received the Final Report on 12 August, decided not to circulate it and accordingly CCB management likewise did not have a copy. The Minister of State (Finance) did not call upon Hitchman to review it with her, though she discussed his Interim Report with him in July. The Minister felt, and not without reason, that any leakage of the contents of this report would be very damaging to the bank. For that reason she did not pass it around.

In any event, at the end of the day none of the avalanche of criticism unleashed by CCB management, even if given full play and credibility, can reduce the report to meaningless proportions. The Hitchman team was qualified. Given the circumstances in which the project was mounted and the pressure under which they worked, the report is cohesive, organized, and on the major issues, sound. Cross-examination on the report and its author was full and unfettered. The objectivity of the Hitchman team was unshaken. Their motives have not been assailed, and they had no interest to protect, at least none was disclosed.

McLaughlan himself acknowledged in early August 1985 that $200M in additional losses on loans, comprised of $100M in respect of Support Package loans and $100M in respect of loans outside the package, had to be recognized by write-off. The capital of the bank at the time was about $120M. Anything beyond the level of the capital raises nothing new on the issue of insolvency, but only on the question of the appropriateness of undertaking a rescue of the bank. It is helpful to scrutinize the Hitchman report and its conclusions through the eyes of someone standing outside the transaction itself and again with no apparent interest in the outcome on the issue of validity of this report. Such a person is the liquidator, MacGirr, who testified, after being in the office of liquidator about three months, that the specific provisions of $65M set up by CCB itself as of 31 August 1985 were "grossly inadequate". He expressed puzzlement about the nonearning loan figure in the financial statements of the bank at the close of fiscal year 1984 in respect of which he said: "What puzzles me is why the bank was accruing these loans [the loans included in the Support Program] before 31 March, 1985 since by the bank's own acknowledgment the support group loans were the worst loans in the bank." As a result of his examination of the accounts of the bank, he came to certain precise conclusions:

1. "By any standard, [the bank was] hopelessly insolvent on August 31, 1985 ... the bank was probably insolvent on March 31, 1985 and there is at least some doubt in my mind concerning its solvency on October 31, 1984."
2. While he was mystified about some of the actions taken and not taken by the bank, he surmised that "reality catching up with everybody" was probably the reason for the sudden discovery of the need for specific loan provisions on a grand scale.
3. Even an additional $100M in the Support Package would not have saved the bank.
4. While he did not agree with all of the calculations and conclusions in the Hitchman Report, the liquidator was very careful to state that he did not want to quibble about the conclusions of that report so as to obscure the critical fact that the Hitchman Report provided the correct, answer and that CCB at that time was insolvent or at the very least "in very serious financial difficulty".

It was quite obvious that the liquidator could not, in his capacity as such, state publicly his opinion on the true value of the securities held by him as liquidator of the bank. He is in the business of realizing the maximum value in the marketplace. His observations, however, support the conclusion that necessary write-offs amounted to several multiples of CCB's capital.

5. Conclusion

It becomes evident, therefore, that the meetings of 22 and 24 March misjudged the state of CCB's troubles. Mr. R. Utting, a retired Vice-Chairman and Executive Vice-President of the Royal Bank, wrote in a report (described in Appendix D) to CCB in August that such misjudgment occurred outside CCB. This may be so, but the misjudgment may well have been based on facts which in part originated in the management of CCB. Governor Bouey acknowledged in a letter of 28 August 1985 addressed to the Minister of Finance, that "evidence [is] now becoming available that demonstrates clearly that the causes of the present situation already existed at the time the official assurances were given. ..." The reference there is to the press release of 25 March 1985. The letter goes on to state: "But the fact of the matter is that the condition of the CCB was seriously misjudged in the process that led to the establishment of the support package". What follows inexorably is that the management of the bank, the first link in the information chain, and the Inspector General did not equip the participants in the Support Package meetings with all the information needed to permit a proper and full assessment of the chances of a successful rescue. Many examples are at hand in the record.

As mentioned earlier, the FRB report on the Los Angeles Agency was received by the Inspector General on 7 March 1985. Oral discussions with the FRB had taken place in February 1985. The Inspector General advised the meeting of 22 March that the sudden collapse of CCB was brought on by the unanticipated and sharp turndown in California energy loan workouts consequent upon an OPEC oil price drop initially of $1.00 a barrel, and that the bank became aware of the crisis in Los Angeles in early February, and in Edmonton on 23 February. The Inspector General did not disclose to the meeting, according to all the minutes and testimony received by the Commission, the existence of the FRB report which was based on facts existing in the previous October. The FRB concluded that not only was the future of CCB's United States Agency brought into question by the state of affairs discovered on the 1984 examination, but also the condition of that Agency threatened the existence of the bank. Yet none of this information reached the meetings on 22 and 24 March when the decision to rescue the bank was being made. Neither were the results of the loan examinations, already discussed, adequately divulged to the meeting.

Based upon the limited information made available before and during the meeting, it is difficult to see how the participants could have constructed a detailed and sensible plan which would have held out some prospect for a rescue of the bank. The concept adopted was, in the light of the facts known shortly thereafter, at best half-baked. The bank was dying because the loan portfolio could not produce the income necessary to sustain the bank's operations. This sharply declining income in turn was destroying the ability of the bank to attract deposits. Without deposits the bank could not make loans, and without rolling loans over and putting in place healthy loans the bank had no future. The object of this Support Program therefore was to replace lost income and thereby protect and renew capital. The banks could not in law contribute equity capital, and the government agencies likewise were not in a position, either legally or practically, to do so. Resort was had to what amounted to a long-term loan repayable out of the prospects of collections from bad debts and future earnings. The money infused, therefore, could not be treated as capital, but only served to reduce liquidity advances. Thus, the $255M was simply a liquidity advance and, as Governor Bouey told the meeting when it opened on 22 March, the problem was not liquidity but solvency. This was the philosophical cleavage in the program as it evolved from the weekend meetings. Other problems arose. Expressed in general terms, these problems suggest certain lessons for the future (to which the Commission returns in the Recommendations).

1. There was no authorized leader (either legally or practically) with the power or authority to direct the design of the program from inception of planning to completion of the execution of the established plan. Subsequently, no single authority was placed in charge as manager of the program with instructions to report back to the participants periodically or at all.

2. No committee of representatives of the participants was established to receive progress reports from the manager of the program. Nor did the meeting assign to the Inspector General any precise program for the gathering of information and the monitoring of the support program and no clear method or apparatus was established to adjust the plan if monitoring revealed a need to do so.

3. The bailout design assumed that the existing management of CCB could successfully manage the bank thereafter. Even if this assumption was correct, some would suggest that the plan should have involved, if confidence were to be re-established in the deposit market, a replacement of the senior management of the bank and, at the very minimum, a reinforcement of its Board of Directors.

4. Although serious difficulty was encountered by the rescue program in the planning stage, the preparation for the meeting by the OIGB was clearly inadequate. The participants were not clothed with the known statistics about the CCB nor was a detailed written report received from the OIGB representatives in Edmonton before the meeting, even though those reports must have been available by 21 March and certainly before the meeting on 24 March. No mention was made of such essential documents as the FRB Report on the California operations of the bank. In short, the meeting launched itself into the establishment of a rescue program before the participants in the meeting understood the state of affairs of the bank which was the subject of the rescue.

5. That the $255M infused into the program was inadequate is transparently obvious. It might have achieved solvency for the

> bank but that is very much in doubt from the evidence before the Commission. What is not in doubt is that a successful program would have involved a massive infusion of funds far in excess of $255M. It also would have involved a plan structured to insure an immediate flow of income to the bank and a reasonable prospect that such positive flow of income would continue for the foreseeable future. Finally, such a program would have had to insure either the elimination of the present stockholders and their replacement on some future disposal of the bank, or some intermediate solution involving the use of warrants held in trust, not by competitor banks, but by a public institution such as the CDIC. Some form of agreement would be required whereby any benefits obtained by CDIC in the disposition of the warrants would be shared with the support group members in proportion to their cash contribution to the Program.

All of these comments on the rescue program are consciously expressed in generality. The precise nature of a successful bailout must, as the structure of bailouts in the United States and the United Kingdom detailed in Appendix B shows, reflect in detail the exact condition of the assets and liabilities of the bank, earnings expectations, management and many other factors. The Commission is here concerned only with comments on the general principles involved in such arrangements. Precise recommendations for the future are made later in this Report.

The Commission concludes from all of this that this bailout was ill-starred from the outset and had no chance of success. The crunch came on a Friday with a decision required before Monday morning. The atmosphere was frantic and not conducive to the production of a cohesive and detailed commercial contract. As later observed, the delay in determining to put public funds into a bank rescue ate up time needed to design and implement a workable rescue program. That is not to say that a bailout should not have been undertaken or that those who undertook it acted irresponsibly or negligently. What must be said is that the institution of bailout in the recovery of banks should not be written off on the basis of the experience in the CCB. A rescue program properly designed, efficiently executed and overseen by qualified public and private authorities may be appropriate on future occasions if and when banks fall into difficulties. Sometimes a rescue may well be hopeless. Other times it will be the proper course of action. The complexities of the banking industry are such that however thoroughly the information may be assembled, however carefully the plan be designed, and however intelligently and energetically it be executed, a successful rescue cannot be guaranteed, with but one exception: when unlimited funds are committed. The decision therefore is complex and the final considerations must be the essentiality of the bank to the system and the community, and whether the cost does not outrun the benefit. The supervisory system, including rescue programs, must be founded on the understanding that commercial banking will produce failures and that it is not in the interests of the community that all such bank failures should be rescued.

C. EVALUATION OF THE SUPERVISORY PROCESS

1. Management

CCB passed through two distinct and separate eras. These two eras in the corporate history called for different talents and styles of management. In the first era, the formative years, the bank saw the boom into which it was born in the mid-1970s accelerate into the early 1980s. In this period, most if not all businesses in Alberta of any size and importance flourished. Profits were universally good, assets expanded, credit was easy, inflation seemed to be beneficial, very few business failures occurred, and unemployment was low. The bank grew in the sense of expanding its loans to the borrowing public by leaps and bounds. Profits grew to match this loan asset growth, and of course, so did its deposit indebtedness. The bank increased its capital sufficiently rapidly to maintain debt/capital ratios within the tolerances prescribed for the industry by the regulator. CCB also extended operations into Eastern Canada and down to California with a view to seeking diversification in both market and sectors of industry. Unhappily, this coincided with the onset of the slowdown in the western economy upon which the bank was largely dependent in its boom years. The early management of CCB made a strategic error in its lending practices by taking on loans on the scale of the big banks. Large loans, sectoral concentration, and a small number of borrowers were the results.

This takes us to the second era in the bank's history. In the rapid growth of the loan portfolio some loans were made which remained in the portfolio to haunt the bank in the lean years ahead. The troubles in the portfolio were seriously aggravated by the energy slowdown in 1981 followed by real estate and a general economic turndown in 1982, accelerating as the 1980s unfolded. This slowdown exposed weaknesses in the bank and in the bank's customers.

In these circumstances, bank management had two new and demanding masters. First, the bank had to protect its income so as to retain its attractiveness to the money-depositing market. Second, it had to protect its capital by protecting its primary assets, the loans. This it did in large part by deferring classification of bad loans wherever possible. This was accomplished by accounting practices which included the recognition of accrued, but uncollected interest, capitalization of interest, and the deferral of making specific provisions against loans for anticipated loss which in better times would have been indicated and taken by the bank. By 1982, management faced the need to realize that its gamble on continuing western prosperity had failed, and that a serious economic reversal faced the bank in all its principal areas before it had attained a stable source of deposit funds and a sectorally and geographically diversified and sound loan portfolio.

If this second era had a theme it would be wrapped up in the word "workout". By this method management, depending on one's viewpoint, either turned its back on bad loans and hoped they would go away with the return of good times in the economy, or accepted the challenge and attempted to restructure loans so as to enable the borrower to meet its obligations partially for the moment and fully at some unknown time in the future.

As has been described earlier, the bank's various workout techniques did not succeed, and in the end management was forced to lay its case before the Government of Canada and seek sufficient financial support to prevent a public declaration of insolvency. Unfortunately for the future of the bank and perhaps for the public generally, management did not describe the extent of its troubles in the proposed rescue program fully and accurately. It perhaps did not appreciate, or in any event did not reveal, the true state of the loan portfolio, the magnitude of its current and prospective losses, and the amount of money required in order simply to survive. It is difficult to appreciate why management of the bank underestimated these problems. Perhaps it was a simple failure to accurately assess the magnitude of the depreciation in the portfolio and the resultant impact on the earning powers of the bank. Perhaps management did appreciate the extent of the decay in the loan portfolio but realized or feared that a full disclosure of the magnitude of the problem and the moneys required in support would scare off the Government and the financial industry whose support was now so desperately needed.

The difference in capital structure and asset spread across the spectrum of industrial-commercial activity and geographic regions, distinguishes the major banks and their experience in the Western

Canada economy in the 1980s from that of CCB and Northland. Hence the conditions in these two groups of banks are incomparable. The difficulty arose in CCB because its management scaled the lending operations according to the strengths and assets of the major banks instead of scaling these operations to their own strengths and assets. Consequently, when the inevitable downturn in the economy came, particularly in the cyclical industries of real estate and energy, new banks which were the product of doubtful design, rapid expansion and imprudent lending policies, such as CCB, were exposed to adverse economic winds and their destruction was inevitable, at least without extensive outside aid. All this must be the conclusion drawn from the evidence introduced in this Inquiry.

The evidence equally reveals a dedication by management to preserving income and the values of the loan portfolio in the balance sheet, all to the end of presenting financial statements which would enable the bank to survive. Without this effort and ingenuity, of course, the bank would not have survived from 1982 through 1985. Whether these practices found their way into the reports of the regulator and the audited financial statements of the bank, and if not, then why not, are issues to be considered below.

The management of CCB cannot be faulted for their courage, energy, industry and ingenuity. To the last day of this bank, the effort to survive was maintained. Unfortunately, it must be said that in its efforts, management, by adopting the survival tactics already examined in detail, went beyond the lines of proper and prudent banking practice. The actions taken, although in some specific situations they might be within the bounds of propriety, led to a general condition where the financial reports were a facade. The reality was, and had been for some time, a bank with inadequate and declining earnings, sagging asset values and waning credibility in the financial community. A sudden return to the western economy of the boom of the late '70s and early '80s might have saved it. The current world slump in the price of oil would most certainly have finished it off. Management knew the rules of banking and exhibited its abilities to run a bank successfully. On this occasion, caught with a low-quality loan portfolio, and a severe recession, they should have faced reality. A timely effort to merge or reorganize might well have succeeded. Even had such efforts failed and liquidation then ensued, it would have reduced or avoided the losses suffered by those who, believing the bank to be sound, dealt with it or invested in it.

All this must be read in the awareness that the extensive record reveals no evidence of self-enrichment or improper personal financial gain or advancement. This is simply a case where the ends did not justify the means.

2. Directors

The first element of management is of course the directors. In CCB it is difficult to discuss the directors as an entity given the fact that over the course of the bank's life 43 persons served on the Board of Directors, and that of these, only 4 served from the incorporation of the bank to its liquidation. The bank experienced two distinctly different eras of leadership at the board level. The first was under the leadership of W.H. MacDonald, but it is more accurately described as the Eaton era, which came to an end in January 1983 with Eaton's resignation as Chief Executive Officer and as a director of the bank. Paul Britton Paine became a director in September 1983 and Chairman in November 1983. He served to the liquidation of the bank.

On the surface at least, the corporate organization of CCB was conventional. Paine, with whom DesBrisay substantially agreed, offered the following description of the role of the Board during his tenure:

> Firstly, it is to establish basic objectives and broad policies of the corporation ... Secondly to appoint corporate officers, advise them and approve their actions and assess their performance; thirdly, to approve important financial decisions and actions ... budget, strategic plans, compensation, financial audits and ensuring that proper annual and interim reports are given to shareholders.
>
> On the more technical and less important side ... are the approvals of changes in corporate assets ... the issuance of securities ... the declaration of dividends, the delegation of special powers to others ... appropriate filing with the various regulatory authorities. ...

The Board of Directors relied upon four principal sources for their information about the bank's operations: (1) management; (2) the external auditors and their meetings with the Audit Committee of the Board; (3) the internal Inspection Department of the bank; and (4) the Office of the Inspector General. In CCB, the bank did not obtain the same type of information from the internal Inspection Department as is the case in the major banks because the CCB Inspection Department did not assess and classify the quality of the loan assets of the bank, that is, the accuracy of management's classification of these loans or the adequacy of the loan loss provisions taken by management.

The Board operated through various committees including the Loan Committee and the Audit Committee, which are of principal interest to this Inquiry. These two committees were conventional in their constitution and authority within the corporate procedures. Of concern is the question whether the Board derived the appropriate information and reactions from these committees.

DesBrisay, one of the original directors of the bank, discussed the general involvement of the Board in one important matter, the approval of workout schemes adopted by management:

> Q: Were there any limits as to what they [management] could do that was imaginative [in the context of workouts] without getting board approval?
>
> A: What would be proper and acceptable by accounting standards and by banking standards. They [management] were the determinants of that.

Another interesting illustration of the lack of awareness on the part of the Board of important management decisions is the "Bank Sponsored Drilling Program" (BSDP). This program effectively put the bank into the oil drilling and development business, albeit through the back door of workouts. DesBrisay testified that he did not "think that [the BSDP] is something which would require the involvement of the Board." The general issue of management workout programs is important in the analysis of the causes of failure of the bank. It is a conventional, commonplace activity in banking to undertake a workout program for the legitimate purpose of assisting a borrower in the return to normalcy in its relationship with the bank. Liquidation of a loan is a last resort and a generally unprofitable alternative. It has long been seen as good banking practice to stay with the borrower so long as possible and refrain from repossession of security held. On the other hand, it is obviously not good banking practice to undertake a workout for the artificial reason of avoiding management's recognition of a bad loan. The questions are when management should refrain from undertaking workout programs for the improper motives that offer certain attractions to management under pressure, and the responsibility of the Board of Directors of the bank to see that management refrains from doing so. Since these programs were a substantial immediate cause for the failure of the bank, these are vital questions to this Inquiry.

The position of the Board in the last years of the bank cannot be viewed in proper perspective unless one recalls the experience of the Board in the successful opening years of the bank's life under the Eaton leadership as described in Appendix C. The Eaton management was initially well received by the OIGB. Following the 1982 inspection of the bank by the OIGB, Eaton was able to report the results of that inspection to the Board as follows:

> Asset quality, in which he was more than satisfied; liquidity which would seem to have very good support arrangements; and cost overheads which were not faulted in any way. Mr. Kennett's general comments were positive and the bank was noted for being in control of itself. No regulatory reporting

> deficiencies have occurred. He was especially pleased with our loan policies and pronounced them responsible. His staff were particularly complimentary about the bank's management information systems. ... Comparatively we were told that we were doing well against other banks.

Even as the halcyon years of the early Eaton leadership came to a close, many on the Board were beginning to realize that there was something wrong in the bank management. The evidence of DesBrisay and others shows that the operations of the bank drifted away from the immediate knowledge and control of the Board as Eaton's personal objectives gradually diverged from those of the bank. The Board eventually recognized this and, assisted by the Inspector General's letter of 5 November, 1982, brought about the end of the Eaton administration of the bank. Another incident spurring realization of trouble by some directors was the acquisition of the 39 per cent interest in Westlands Bank in September, 1981. This venture was led by Eaton. A number of members of the Board strongly objected to the investment because Westlands was obviously an undercapitalized bank with what was "in reality a negative capital of some $7 1/2M [supporting] ... gross assets of approximately $175M". The majority of the Board overrode the protests of the minority and in doing so committed what stands out as the first strategic error leading to the end of the CCB. This may not have been the case had management properly monitored Westlands as the acquisition plan proposed. In fact, "Westlands became a taboo subject at CCB Board meetings and questions addressed to Eaton were turned aside".

Not on the same scale of capital squander was the expensive experience of the bank in retiring Eaton. In the final settlement regarding Eaton's departure, CCB agreed to purchase the Eaton residence to avoid a costly foreclosure action, and to write off residual stock loans. Total costs were estimated at $750,000, but eventually exceeded this amount.

In the McLaughlan years the relationship between the Board and management underwent further changes. There is no doubt that McLaughlan, having been the President of the bank since May 1982, came into the chair as Chief Executive Officer with a full awareness of the difficulties the bank had in its growing volume of bad loans. One of the measures initiated in 1982 on a small scale, but in full scale by the fall of 1983, was the adoption of a change of policy in the valuation of the loan assets of the bank. Again the Commission is dependent upon the evidence of DesBrisay, who testified that the Board of Directors "were informed that management was reporting to us and the Loan Committee nonearning loans on the same basis that nonearning loans are determined by other banks ...", and that he knew of no change in

1982 or onwards. In the meantime, the evidence is clear that the management of CCB with, from their viewpoint, the best of intentions, had adopted a new mode of valuing security held by the bank. As mentioned earlier, it was a future value concept under the label "baseline value".

The Board not only did not become aware of any change made by management in asset valuation policy but, if the evidence of DesBrisay is representative, did not really believe that management had adopted the use of future values or baseline value in the computation of the worth of the loan portfolio.

> Q. Well, did the board appreciate, wher. they were told about this change in practice, that this going concern concept involved this kind of thinking, that the economic conditions are bad, appraisals now indicate that this property is only worth X dollars, we think conditions are going to improve in the next couple of years at which time it will be worth X plus Y, therefore, for the purpose of determining whether we capitalize interest we will assume the property is worth X plus Y which is the baseline value. Were you aware that is the way in which they were doing it?
>
> A. Well, I do not think that that is the way they were doing it.
>
> Q. Just answer the question. Were you aware that that is the way in which they were doing it?
>
> A. Well, I can answer the question, but I do not think that that is the way they were doing it.
>
> Q. You were not told that that is the way they were doing it?
>
> A. I do not think that is the way they were doing it.
>
> Q. Were you told that that was the way they were doing it?
>
> A. I am sorry. My understanding was that they were valuing the properties, or the worth of the customer, on the basis that the customer was a going concern and that if it was necessary to liquidate that which the customer had the valuations would be based upon an orderly realization of those assets, not what would bring if sold today.

Paine in his testimony, while not in agreement that management were applying future values, did agree that where there demonstrably was no market in which an asset's value could be realized, it should be the subject of a loan loss provision. This conservative attitude in the Chairman was also reflected in his approach to marginal and unsatisfactory loan classifications. He testified that this category of loan had slowly increased from 21 per cent of the total loan portfolio of the bank at 30 September 1983 to 24.6 per cent a year later, and finally to 29.8 per cent at 31 December 1984.

> This meant that between $750M and $800M of the total loan portfolio fell into this category. Some of the increase came about because I encouraged the Loan Committee to take a more conservative approach to such loans, some of which had not before been placed in this category and in my opinion should have been.

The truth probably is that had Paine's conservative approach to loan classification and provisioning, and particularly the latter, been followed by management, the bank could not have survived very much beyond the end of fiscal year 1983. It follows that had the directors known about the use of future value concepts in the valuation of loan assets with the derivative effect upon the bank's income and asset statements, the bank could not have survived. Its earnings would have disappeared, and the sharp losses to be encountered, together with the diminution of the value of assets on the balance sheet, would have made the raising of deposits either impossible or too expensive to be practical. The evidence of Paine is buttressed by that of the Chairman of the Audit Committee of the Board, who testified that, while the auditors were concerned about some of the bank's accounting practices, the Committee did not feel that the auditors were unduly alarmed and they were prepared to sign, and did sign, the financial statements. Had the Chairman's policy or outlook been applied by management, insolvency may not have ensued. The state of the bank's finances would have been revealed earlier. The chances of successful merger or reorganization were very much better in 1983 than in 1985.

In order to fill out the shape of the strange and ironic dilemma of the bank in the 1980s, it must be pointed out that throughout this period the directors were, of course, faced with the reality that the independent external auditors of the bank continued at each fiscal year end to certify that the financial statements as prepared by the management of the bank fairly represented the financial state of affairs in the bank. The irony is graphically illustrated by the comments of Paine who, faced with the evidence that the Bank had capitalized $59M of interest on loans over fiscal years 1982 through 1984, stated that the OIGB and the auditors must have been "blithering idiots" if they had failed to discover it. It makes it very difficult in these circumstances to assign to any individual director a substantial degree of fault for the ultimate failure of the bank by reason of his inability to respond to the true condition of the financial affairs of the bank. It may be that the directors' responsibility narrows down to the question whether the bank was allowed to continue in its insolvent state beyond the time when it should have been so found, and its structure reorganized or its existence terminated.

The suddenness of the end of the bank was no doubt felt as much by the members of the Board of Directors as by the regulators. The

Board was not involved by McLaughlan in any significant way prior to 14 March 1985. So far as the record reveals, only Hillman, the Chairman of the Audit Committee, had knowledge as early as 11 February 1985 of the impending calamity in the energy loans of the bank in California. Neither he nor McLaughlan relayed this information to the Chairman of the Board in an executive meeting on 4 March prior to the director's meeting on 5 March. Even on 5 March the Board was not apprised of the details of the losses incurred in the U.S. Agency in both energy and nonenergy loans, although the record is clear that these details were in the possession of McLaughlan at the time of the Board meeting on 5 March. In fact, McLaughlan allowed the Board to defer decision on the crisis until a subsequent meeting on 19 March by which time he would be able to carry out the edict of the Board to gather the precise details of the extent of the loss facing the bank from these energy loans. All this was in his possession prior to the meeting of 5 March.

As to the process leading to establishment of the Support Program itself, the Board was not involved in the meetings of 14 March, nor the ensuing meetings on 22 and 24 March except to convene an Executive Committee meeting in Edmonton on the latter date so as to approve the Support Package as finally put together at these meetings by the regulators and the major banks. In the final analysis, however, the directors of the CCB were on a take-it-or-leave-it basis, or as the evidence has it, "sign or die".

The fault of the Board, throughout its history, has been its susceptibility to mesmerization by management, first by Eaton and his lengthy period of success, and secondly by the industry and apparent achievements of McLaughlan. Some members of the Board came to realize in both instances that management was not effectively managing the affairs of the bank, but realization came to the majority too late. In the Eaton era such episodes as the Westlands acquisition placed the future of the bank in serious jeopardy. In the McLaughlan era the struggle against oncoming insolvency was not fully analyzed and appreciated by the Board. Hillman's failure to report immediately to the Board or to the Chairman on his February 1985 visit to the Los Angeles Agency and the impending calamity there, is illustrative of the lack of adequate response on the part of some directors. If there is one key to the troubles encountered by the Board in directing the affairs of the bank, it was their composite failure to insist upon simple and straightforward regular and timely information from management. The institutions and processes were in place in the government of the bank but they did not function because management did not deliver and the

Board did not demand a flow of the basic information necessary to the control of the affairs of the bank and to keep management within the policies as laid out by the Board. The Board's difficulties were increased or perhaps even caused by the failure of the auditors to fully alert the Board as to the practices of management in interest accrual and capitalization, loan loss provisioning, asset evaluation and workouts. It is difficult to disentangle these forces which brought about a semi-paralysis in the Board of Directors of the bank as the final governing agency in the corporation.

This subject cannot be closed without observing that a board acts through a dynamic shifting majority. It is each director, not the Board, who is under certain duties, and the conduct of directors can only be assessed individually. Thus it is most unfair to lump all directors together in any assessment of board action. Some longtime members on the CCB Board swam against the management current through many years. Some recent additions to the Board recognized many of the problems of the past. Others seemed to make little contribution. The Board here, of necessity and for the purposes of the Commission's mandate, must be assessed and adjudged as a unit over the life of the bank. Individual members may well suffer from a description that does not fit their individual records as directors.

Like the auditor who has one powerful last resort power, the directors can resign. Where the corporation is proceeding in a direction perceived to be wrong, the director must withdraw. It is often more difficult to do so where the director represents a large shareholder. Nevertheless, his higher duty is to resign in such circumstances. In the course of the CCB history, some directors with better knowledge or training, in all the circumstances, might well have dissociated themselves from the bank by resignation. That no one did so in CCB is not evidence necessarily of a lack of perception of duty. Founding directors would not find it easy to turn the ship over to someone who is seen by those founders to be destroying the original plan. The Board here, as a unit, must share some of the responsibility with other elements in the corporation for this ship which sank under their feet with a crew on board for which the Board of Directors were responsible.

3. Auditors of the CCB

The Commission now turns to the actions taken by the external auditors of CCB in relation to banking and accounting practices generally found in Canadian banking. These practices, as explained to the Inquiry, are described in Appendix F, and are briefly reviewed here for convenience.

The auditors have the duty of deciding to approve or not to approve the financial statements prepared by the management of the bank. Their approval is granted, as we have seen, by certifying to the shareholders that the financial statements present fairly the financial position of the bank and the results of its operations for a specified fiscal period. Of course, pursuant to provisions of the *Bank Act*, the auditors have additional duties to the Office of the Inspector General and, through that office, to the Minister of Finance.

The auditors know as a fact that in the operation of the bank the directors, management and Inspector General share considerable information. One of the positions taken by the auditors in this bank is that the other two elements in the triangle, that is management including the directors and the regulator, were fully apprised of the situation in the bank through discussions with the auditors. This question frequently arose in the hearings: if the auditors accept the valuation placed upon assets in the process of workout by management, are they exonerated from any error in judgment in that regard by reason of the fact that they have fully advised the directors through their Audit Committee and the Office of the Inspector General, of any doubts or differences with management they may have had? Whether that consequence follows or not, the immediate and only real question is whether the financial statements, on which the auditors expressed their opinion, presented fairly the financial position of the bank.

We start with the presumption in the field of accounting that the subject of the audit, here the bank, is a going concern, but in the words of one of the expert witnesses, "One of the responsibilities of the auditor is to satisfy himself that the going concern presumption is valid" in this instance. Dilworth testified that where there was a perceived threat to the going concern assumption, then the auditor was obliged "to use more conservative" valuation methods in determining the accuracy and fairness of the financial statements. One of the great arguments before the Commission was whether in this process the auditor must value the assets on a "liquidation" or "going concern" basis. Dilworth brought some precision to this debate by pointing out that as a practical matter, where a circumstance developed into a serious recognizable threat to the going concern status of the bank, the auditors must, in valuing the assets of the institution, take into account periods of realization closer to the liquidation process in valuing the assets. Of course, the entire process requires that it be carried out with regard to whether a given issue or piece of evidence is "material" to the fundamental question whether the financial statements fairly present the position of the bank.

The test of materiality was very neatly put by Broadhurst:

> In addition to the various mechanical tests, such as percentage of normalized profit, percentage of total loan portfolio, or some other measure I would like to ask myself one further question, and that is: If the adjustment that I am after was booked, is there a good chance that the readers of the financial statement would take away a message, after the adjustment, which would be different from the message that they would have from the financial statement without the adjustment and, as a result, take a different course of action? This is also subjective.

Materiality is by definition a flexible concept. The scale of materiality of an item in question will vary according to the ratio it represents as compared to the quantity the event may be said to have influenced. Here the CCB auditors had determined that a million dollars was the level of materiality. This was set in 1982 based upon an estimate of "normalized" income of $12M. By fiscal 1984, the earnings in a current cash sense had disappeared entirely, there was a loss of $6.9M from operations, and only by the recovery of income taxes was an income of $800,000 produced. In simple logic, the level of materiality of $1M has no application to a bank with a profit of less than $1M. The scale of materiality reflecting the initial yardstick adopted by the bank's auditors would produce a materiality reference of much less than $1M. This is in accord with the testimony of Broadhurst and Dilworth.

The valuation of loans, the principal assets of a bank, is based on the valuation of the borrower's covenant, or where that has disintegrated, the underlying security held by the bank. Thus the security posted by the borrower is regarded as a "fall-back position". The valuation is of critical importance because in turn it determines the ultimate collectability of principal and interest on the loan in question. The auditor witnesses were unanimous in their view that, however the asset of a bank is valued, the decision should not be based upon an economic forecast by the valuer or anyone else. Broadhurst testified that he "would be alarmed if these assumptions [future economic conditions] included a significant improvement in the economic circumstances." Indeed he agreed that such a practice would be "dangerous".

Broadhurst went on to discuss the process of setting up loan loss provisions against the loan assets in the bank's portfolio:

> Insofar as provisioning of loans, I believe there are two essential approaches. One is the examination of certain individual loans, and the second is a stepping back and viewing the overall loan provision in the light of trends noted and judgments made in the examination of individual loans.

Of the two steps or approaches, he considered the second step as of transcending importance. When valuing a series of assets, particularly where the valuation is an interlocking process, common sense requires an overall view of the result. Broadhurst refers to this as a "stepping back" and that view is shared by the other expert witnesses.

With regard to the subject of capitalization of interest (in an "unplanned situation", that is outside the initial loan contract), Broadhurst testified that the practice was a "warning signal" to an auditor. The rule in bank auditing, in his view, is simple. This practice should not be undertaken if there is *any* doubt of the collectability of principal and interest on the loan, nor should it be undertaken where the total principal and interest would exceed the value of the security held, valued without reference to expected values at some time in the future. The basic problem facing the auditor, it would appear, is to decide whether a decision by management in the course of banking, which for convenience is referred to as an operational decision, necessarily ordains that the proper accounting treatment to be accorded to the transaction when reflecting it in the financial statements of the bank is that proposed or applied by management. The expert evidence mentioned above was clearly to the effect that it does not. The auditors of CCB, on the other hand, felt bound by the accounting treatment accorded by management to their operational decision. The auditor, of course, has access to all records of the bank and can review the file or a series of files on a spot-check basis and determine why a provision was or was not taken against the stated value of the loan. In addition to Broadhurst, the liquidator of CCB was of the view that the decision by management to work out a loan, in contrast to simply liquidating the loan, was not a bar against taking a provision immediately and thereafter adjusting the provision and the net value of the asset upwards and downwards as the fate of the workout is unveiled. MacGirr testified:

> However, an election to wait on the disposal of the underlying security, in my opinion, should not affect the setting up of appropriate provisions. If it were otherwise—I guess it is obvious—a bank could escape setting up any provisions by simply electing to hang on to all of its bad loans.

In the debate on this issue before the Commission, counsel for the auditors and others sometimes submitted that it was no part of the role of auditors in the valuation process to substitute their judgment for that of management on the determination of the proper balance sheet value of an asset. It is helpful to set out one of many references to this issue by Broadhurst:

> When an auditor reviews any doubtful loans to which management has already made a judgment, it is my view that the auditor must be prepared, based on his own judgment, and within the context of his overall view of the loan provisioning in that organization, to disagree with the judgment of management and to consider the need for a qualification of accounts if an increase in the specific provision that he feels is necessary is not made and it is material.

From all of these experts comes one rather clear and simple key warning. Where the interest is not being paid from the borrower's own cash, Mackenzie said:

> [T]hat's where the focus ought to be because if the bank cannot generate *that kind of earnings* that will be a reflection of a host of other problems, nonperforming loans; it could be a reflection of the fact that they have a concentration of assets in real estate, oil and gas or shipping or whatever, but it is to me the key indicator, and *a key thing to look for*. (emphasis added)

An examination of the detailed evidence, both testimonial and documentary, indicates that the audit firms of CCB, in the year 1984 and probably in the year 1983, did not adhere to the principles enunciated by the three experts which have been summarized above, when determining whether to approve the financial statements as prepared by management. The evidence is clear that, at least with respect to the 1984 audit, the auditors put in a very considerable number of person days (about 300) and in the course of so doing examined about 65 per cent of the entire loan portfolio. In the course of such an examination the auditors should have come across the practices which have been discussed here, namely, the valuation of assets on the basis of future realizations in different economic circumstances than those prevailing at present, the recognition of accrued interest, the capitalization of interest, and management's decisions regarding loan loss provisions.

It is clear from the evidence of the auditors themselves that they were aware that bank management was valuing the loan portfolio and the assets held in security therefor on the basis of "a timeframe of three to five years to see some positive results by way of a turnaround" and that such a basis "... seems reasonable to us". Later on, Lord, on behalf of the CCB auditors, stated in answer to a question from Commission counsel:

> They [management] were really saying two things ... they were saying that our business judgment is that it would be inappropriate to sell the property in today's market and then they were saying we expect a recovery, we will sell the property after the recovery has taken effect in a more orderly market where there are buyers and their business decisions was to hold the particular assets and sell them in a more orderly market ...
>
> Q. And the expectation of recovery is based on a judgment on economic factors, is it not?
>
> A. (Lord) Yes.

This valuation basis necessarily inflates the value of the asset over and above the present market; otherwise, recourse to the future value basis for valuation would be unnecessary. The result of the inflated values of assets is the advantageous effects on the income statement and the balance sheet as already discussed.

All this leads back to the initial question, has the bank made the operational decision to work out the loan and thereby revise the value of the asset on the basis aforesaid simply for the purpose of mandating an accounting treatment which produces beneficial paper results? If the auditors are bound by operational decisions, the decision of management would not be subject to audit review and the auditor would be free to certify management financial statements as fair almost on an automatic basis. As MacGirr put it so succinctly, if the auditor is so bound by the operational decision, then a bank may avoid ever having to take a provision or ceasing to recognize accrued interest by simply determining values on a basis which would maintain the classification of the loan and justify the continuance of these practices. In short, if the bank in the view of management cannot afford to "take the hit" which would by proper accounting treatment have followed, management would simply make an operational decision to work out the loan and maintain values at a level justifying the deferral of loss provisions and the continuance of income recognition.

Lord and Carr, while maintaining that the operational decision dictated the accounting treatment, and thus foreclosed the auditors from anything approaching a substitution of their judgment for that of management, acknowledged that at least they were able to properly maintain a list of specific reserves which they proposed should be taken in each financial year and a record of those proposals which were rejected by management. The provisions proposed by auditors and rejected by management amounted to $18M in 1983 and $11M in 1984. The auditors say they accumulated this "so that we may have some idea of the range of differences in our opinion from the bank's". Materiality appears to have had little to do with the problem facing these auditors. The $18M in 1983 would have been charged against income through the five-year formula for loan loss provisions and credited against the Appropriations for Contingencies Account on the balance sheet. In 1983 the before tax income was $8.2M and the net income was $6.5M, and in 1984 the bank was in a loss position of $7M before recovery of income tax, producing a net income of but $800,000. Had the auditors insisted on adjusting the provision for loan loss as calculated in accordance with the five-year averaging formula and charged to the statement of income, there would be a reduction in income before tax of $5.5M in 1983 and of at least $2.8M in 1984. Notwithstanding the obvious materiality of the rejected provisions, the auditors in their testimony stated: "... we are not in a position to say our position is correct and the bank's position is incorrect. ..." In this they seem to be in fundamental disagreement with the testimony of Broadhurst and Dilworth. It is for no purpose to argue that these "differences" are not material when measured against a $2.2B loan portfolio. The gauge of materiality here applicable is the level of earnings and the balance of appropriations for contingencies which would be reduced or even wiped out.

It can be stated in summary that the same line of reasoning was applied by the auditors to their position vis-à-vis management in a decision by management to override the rule requiring the cessation of taking into income accrued interest. When management have determined that there is no reasonable doubt as to collectability of principal and interest and thereby invoke the management override, bank auditors, in the view of the CCB auditors, are powerless. They may have tested the "reasonableness" of management's judgment, but they accepted that judgment in many instances where it was patently unreasonable. Again, the position taken by the CCB auditors is squarely against the testimony of the accepted professional accounting witnesses.

Lastly, the auditors take the same position with reference to the decision by management to work out a loan which otherwise would fall into the nonperforming, or nonearning category. In this situation, the auditors for CCB took the view that once management has taken such a position, the onus is on the auditor to demonstrate the error of management. The auditors' testimony on this third issue is even clearer:

> The bank has made a business decision and unless there is *no* evidence of any possibility of continuing, it is a bank decision to treat the loan as a going concern loan and, accordingly it is not possible to categorically, as auditors say in those circumstances, [state that management's] valuation as a going concern is inappropriate, because the decision has been made to continue with the customer on a going concern basis and there is a program in place to do that.

Reduced to its simplest terms, the auditors say that they may only reverse a management decision on this point where there is no evidence of the possibility of a borrower continuing in business. In effect, they have subscribed to a rule that the management decision to put the loan into a workout carries with it as a concomitant the decisions that there shall be no loss provision taken, that accrued interest shall be taken into income, that interest so treated in the past shall not be reversed, and that they are, therefore, powerless to take the opposite view and to insist upon its implementation and reflection in the financial statements of the bank. This proposition clearly flies in the face of the principles enunciated and accepted without qualification by Broadhurst, Mackenzie and Dilworth. It also virtually denies any real purpose in having external auditors.

Apart altogether from the technicalities of accounting rules, it offends common sense that a bank with the level of unsatisfactory loans which CCB had in the years 1983 and 1984 could by the simple workout device obviate all need for cessation of income recognition or the taking of provisions against losses. Thus on principle and in detail the practices followed by the auditors of CCB in reviewing the financial statements proposed by management were clearly in error, and as a result the financial statements, contrary to their certification, at least in the year 1984, clearly did not fairly reflect the financial position of the bank.

This conclusion logically follows from the report by the auditors themselves to the Audit Committee of the bank in the years 1982 through 1984. It is instructive to review the highlights of the audit observations they made. The auditors noted a change in interest recognition practices for 1982. There was a significant increase in 1982 in the number of noncurrent and nonearning loans. In past years, the bank had discontinued accruing interest on loans and reversed prior accruals where interest arrears exceeded 90 days, but in 1982, the bank established a practice of recognizing interest based on assessment of each account and, in particular, on underlying security values rather than adhering to the 90-day guideline. They expressed concern about specific loans where uncertainty existed and interest was nevertheless recognized. As in the case of specific provisions, the auditors stated that they were not in a position to conclude that the bank would not likely receive the interest in question. The auditors considered the accounting policy change regarding income recognition to be appropriate as long as security values were "critically reviewed". The baseline value concept, originated in 1982, was not considered by the auditors to be a noncritical review of the security values. They clearly were not put on their guard by these contemporaneous occurrences which together would enable the bank to recognize much more income than it could otherwise do.

The 1983 report to the Audit Committee shows continued and increasing acceptance of management's philosophy notwithstanding the continuing economic downturn. The report stated that the auditors accepted management's judgments as to what the ultimate losses on particular accounts would likely be. They told the Audit Committee that it was not possible for them to take the position that management's estimate in any particular case was clearly incorrect, because bank management is more experienced in the matter of collecting difficult loans than are external auditors, and external auditors do not have the "gift of perfect foresight". That year, the "going concern" concept evolved further into something else, and the auditors noted that, to the greatest extent possible, the bank attempted to maintain the going concern value of the security by taking control of the assets and finding competent new management, thereby buying time for the market value of depressed assets to return to more normal levels. They cited as specific examples some of the real estate loans in Alberta and the drilling rig loans (described elsewhere) in Alberta and the United States. In both cases, the auditors indicated that the success of the bank's strategy in avoiding major losses on these accounts was dependent upon future economic recovery in the Alberta economy and the energy sector in Canada and the United States. Clearly, the accuracy of the auditors' opinion also depended on these factors.

Equally startling was the auditors' acceptance of management's treatment of accrued interest when the security was transferred to a "loan warehouse". Upon transfer of security to some newly created companies, senior management explained that interest continued to be recognized, though uncollected, because of their improved confidence in the full recovery of principal and interest due to the transfer of control of the related security to new and more competent operators. The auditors stated that it was "not yet possible to know how much, if any, of such capitalized interest may not be collected in the future". In the result, management's view prevailed and the uncollected interest continued to be taken into income. The auditors warned that "a significant amount of the problem loan portfolio has been classified as earning" as a result of management's approach. All this was done in the face of the principle acknowledged by the CCB auditors that it is not permissible to capitalize interest unless there is no reasonable doubt of collectability.

The CCB auditors concluded their memorandum for discussion with the Audit Committee in 1983 with the following comments:

1. The bank's policy of capitalizing interest on problem loans increases the difficulty in demonstrating full collectability of these loans.

2. The bank could have justified larger specific provisions on certain loans.

3. The auditors took some comfort from the size of Appropriations for Contingencies Account, which amounted to approximately $24M, and represented additional protection for unforeseen loan losses.

The third comment is clearly contrary to the bank auditing testimony of Mackenzie and Broadhurst who stated that the existence of such an account is no substitute for taking specific loss provisions. Yet the auditors stated in a memorandum:

> The $18.032M [the total provisions proposed by the auditors and rejected by management] can be seen to be easily covered by the appropriation for contingencies account which is meant to cover these "grey areas". At October 31, 1983, the appropriations account has a balance of $23.947 [M]. Because this total is considerably less than the appropriations balance, no further action has been taken at this point.

The position of the CCB auditors taken in their testimony before the Commission was the same as that of the expert witnesses concerning the Appropriation for Contingencies Account, but they explained their concurrence with management on the basis that the loss provisions rejected by management and waived by the auditors were for "unforeseen" losses and accordingly were properly covered by the balance in the Appropriation for Contingencies Account without need for specific loan provisions. Carr said the losses "would be unforeseen as far as the bank was concerned". Such a position represents delegation of responsibility to management in the extreme, and is representative of the position taken by the CCB auditors in justification for their certification of the bank's financial statements.

The memorandum for discussion with the Audit Committee for 1984 again stated that the bank continued to be less conservative than the auditors would like with respect to loan loss provisions, accrual and capitalization of uncollected interest, and recognition and capitalization of fee income on restructured loans and limited recourse workouts. However, on balance, the auditors were satisfied that the total loss provisions were adequate in the circumstances and that the decision to accrue interest and fees "was made only after careful consideration by senior management". It only need be said in summary that the evidence calling for much more conservative accounting practices lay all around the auditors in 1984, but their response was a continuation of the policies and practices of 1983. The auditors acknowledged that the level of marginal and unsatisfactory loans continued to be at historically high levels and losses would continue to be high. In the 1984 memorandum the auditors recorded their concerns that (1) allowing accrued interest to be taken into income increased the difficulty in demonstrating full collectability of those loans where the current value of collateral security was very "soft"; (2) in the case of U.S. drilling rig loans, the bank was still accruing interest in situations where there was a shortfall of the current value of collateral security when compared with the loan balances, and that the auditors would prefer that interest be accounted for on a cash basis until the collateral security was at least equal to the loan balance; and (3) the bank could have justified larger loss provisions as at 31 October 1984.

The 1984 discussion memorandum removes any doubt that the auditors and the Board of Directors at CCB were aware of all the practices management described in these auditor reports to the Audit Committee. There was no doubt that there was an awareness of the extent of these practices. For example, the external auditors estimated that by the end of 1984, approximately $350M or 17 per cent of the bank's loan portfolio was committed to limited recourse workout loans.

By the end of fiscal year 1984, the auditors had manoeuvered themselves into a difficult position. They acknowledged that the large number of workouts in place precipitated by the difficulties in the economy raised a "business expectation" that losses would continue to be high for CCB. They recommended that the Appropriation for Contingencies Account should therefore be maintained at least at the 1983 level. Nevertheless they did not insist that the bank take the specific loss provisions that they had recommended. Their submission on the subject of the Appropriations for Contingencies Account to the Inspector General read in part:

> ... It was felt ... after reviewing all these specific problem loan files that although additional provisions were not required on specific loans, an additional general provision should be available to provide a safety net for the workout loans.

Thus the auditors waived specific provisions which they would have preferred while, at the same time, they were concerned that losses would continue to run at historically high levels. All this cut squarely against the grain of bank auditing as described to the Commission by the bank auditing experts mentioned above. The auditors put themselves in this position by agreeing to the financial statements prepared by management in prior years and then found themselves unable to explain to management why they must now suddenly adopt the accepted standards of the bank auditing profession. Thus they continued to approve financial statements based on standards which were not accepted by that profession.

By 1983, the auditors were able to state that the practices adopted by management reached the very end of acceptable accounting practices, and certainly were not as conservative as they would wish. The earnings trend in the bank was sharply down and future tax credits aside, the retained earnings would have been effectively drained by the end of fiscal 1984. It follows that by that time there had arisen a perceivable threat to the going concern status of the bank, and hence, there was an obligation founded in accounting principles on the auditors, in the words of Dilworth, to use a more conservative approach to valuation. But for the financial statements for fiscal year 1984 such did not appear to be the case.

The conduct of the auditors in the face of but two examples is sufficient to illustrate all the foregoing practices. A loan was made by the bank to the operator of a sawmill wherein security was posted in the form of the undertaking itself together with timber rights. Difficulties arose in 1981, and by 1982, the borrower was in substantial default. A monitor was therefore appointed. The bank continued to fund the operation and to capitalize interest in 1982. The borrowers failed to meet the budget prepared by the monitor for 1982 since markets remained depressed. A receiver/manager was appointed in early 1983. The bank continued to fund the operation. In 1982, the loan had been increased to $6.3M. Interest was capitalized through 1983 and a loan of over $5M was made to the receiver. The total loan increased during the receivership to $13M. This included capitalized interest of over $1M. The loan was transferred to nonearning status in 1984. The bank declined to take a reserve against this loan exposure in 1982 because it was felt that an attempt to realize on the security would result in a significant loss which, it was anticipated, could be avoided when the expected turnaround in the British Columbia economy occurred in 1983. This loan was still in receivership in 1984 but was not included in the list of "waived provisions" compiled by the auditors. The bank, after many failures, located a new operator in 1984 for the sawmill who was said to have expertise but whose principal attraction seemed to lie in the fact that he lived in the area and could concentrate his attention on the mill. The new purchaser offered to buy the security only on a non-recourse basis through a new company with the debt (which was to be increased by $3M to provide working capital to the new borrower) to be paid by an income debenture out of future profits, if any. All this was done in the face of a report that "lumber prices are declining again" and an explicit statement by the purchaser that there was no assurance that the operations would produce sufficient income to service the debt. Overhanging the whole transaction was a doubt about the ability of the bank to transfer the timber rights to the new operator, and a doubt as to the value of those rights, there being some suggestion that a contingent liability to the Ministry of Forests was attached to the rights.

Despite all this, the auditors did not insist upon a loan loss provision in any of the three fiscal years and did not resist management's income recognition practice throughout this period. They expressed their concern in each annual audit review of this loan. They accepted management's excuses year after year about turnarounds in the industry. At the time of the Support Program, management had recommended a reserve of $4M. The Inspector General's first bank inspection team in March 1985 (Tallman) recommended a provision of $9M. The conclusion is irresistible that for most, if not all, of these fiscal periods, the bank in its financial statements held this loan out as an asset with a value considerably in excess of that which management ultimately recognized to be the case, and even further in excess of the valuation according to ordinary bank credit practices.

The second example concerned a real estate loan secured by a third mortgage on an apartment building. There was other security which the bank felt to be worthless or of little value. In fiscal year 1982, the balance of principal outstanding was $5M and the loan was rated 3 by the bank. In 1983, the auditors reviewed this loan and reported that it "was in fairly rough condition but yet the bank continues to capitalize the interest". An appraisal in the bank file revealed that the security was valued at $14M. Taking into account prior encumbrances of $10.6M, the audit reviewer concluded that there was a $2.9M deficiency, but that management had concluded that the correct approach was "from a workout viewpoint". The file also revealed that a prior security holder (another bank which held a second mortgage) with a debt of only $1.8M had taken a reserve. The workout involved funding the development of executive suites in the building. The reviewer noted his doubts that revenue from the development program would be sufficient to carry the debt load, but did not challenge the new baseline value of $18M. The auditors did not include this loan on the list of waived provisions. CCB took no reserve and did not reverse interest accrued and recognized in 1983. In 1984, CCB made further advances so that the total exposure was $8.8M with prior encumbrances now accumulated to $11M. The highest appraisal on file (1983) was $18M. The workout proposal had failed. The situation was only saved by management's assigning a new baseline value to the project of $20M (an increase of $2M over the previous year despite the failure of the workout program). Management's latest baseline value of the property was $200,000 in excess of the total of the prior encumbrances plus the bank's total loan. The reviewer characterized the cash flow forecasts upon which the value was based as "very optimistic". The bank then produced a new plan for the property. In the result, the auditors agreed that no reserve should be taken and no reversal of interest taken into income, all because "CCB is attempting to locate an oil and gas property" for marriage into this nonperforming real estate loan. Again the loan was not on the list of waived provisions for 1984 even though the initial audit review indicated a suggested provision of between $2M and $4M. In the 14 March 1985 bailout review, CCB recommended a reserve of $7M against the principal amount of $8.9M while Tallman recommended "a total write-off".

These are but two illustrations of the hopeless situation produced by the combination of management's operational decisions with reference to nonperforming and nonearning loans and the high level of auditor acceptance of those decisions with all the attendant accounting treatment.

The record is accurately summarized by observing that by reason of the continuing contacts between the external auditors and the OIGB, the OIGB was aware that CCB was using the concept of future value in its assessment of the value of its loan portfolio and that its capitalization and accrual of interest programs and its provisioning procedures were predicated upon such determinations of value. Both were equally aware that the bank's practices were not conservative. Inside the bank it is equally clear that throughout fiscal years 1983 and 1984 at least, the Audit Committee of the Board of Directors was made aware of the uneasiness experienced by the external auditors by reason of the aggressive accounting policies and operational decisions of management and that in the view of the auditors these policies were not "conservative". The Inspector General himself testified on this subject:

> We were finally satisfied as a result of the discussions with the bank and the auditors, that while the practices certainly were not conservative they were within that range. But having in mind always that the satisfaction was a satisfaction derived not from a detailed inspection of the documentation itself of the loans and appraisals, but as a result of a dialogue which finally did give us some degree of satisfaction. There is no doubt about that.

The communication of these matters by the external auditors to the Audit Committee is acknowledged by the Chairman of the Audit Committee, Hillman, who himself is a chartered accountant:

> So, I guess our immediate reaction to the auditors' memorandum was that we were pleased to note that they were prepared to sign the statement and were not proposing any adjustments based on the comments they had made in their memo. While the bank's accounting policies in their view, tended towards the less conservative end of the range, nevertheless, the financial statements apparently fairly presented the financial position at year end in accordance with prescribed accounting principles applicable to the bank industry. We recognize and the auditors also recognize that matters such as income recognition in specific loan loss provisions are based upon subjective judgments in the underlying security. We were comforted that the auditors recognized management's ability in this regard and agreed that it would be improper to base provisions on liquidation values. ... Finally, I guess, that while we were concerned that the bank's overall financial performance was poorer than the previous year, we were not unduly alarmed by the comments made by the auditors in the audit committee memo.
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> . . .
>
> What we were concerned about was why we were reporting a much poorer position. Obviously we have our problems. Did the statements that we were examining present fairly the financial position of the bank at that particular moment in time? And we look to the auditors to express that view to us. The auditors said yes.

Q: They say less conservative but still fair; that is the effect of that is it?

Mr. Hillman: Yes.

Everyone in the tripartite system of responsibility took comfort from the other two members' action or inaction as the case may have been. Having thus discharged what they saw to be their communication obligation, the auditors certified the financial statements as fairly presenting the position of the bank and folded their hands to await whatever action the regulator or the Board of Directors might care to take. However, the ***Bank Act*** puts certain obligations upon auditors to report unsatisfactory conditions. Here the auditors made no such reports. This silence, plus the positive act of certification, induced in the submissions of the directors a false sense of security on their part. In turn, the Inspector General drew comfort from both the fact that the auditors certified the balance sheets and income statements and that the Board of Directors, through its Audit Committee, accepted these statements as fairly projecting the picture inside the bank. In its brief, the OIGB emphasizes the pivotal role played by the auditors in the supervisory system. Its basic position is that it received information from management and the auditors, and had no reason to question that information. It acted responsibly in cases where it received bad news, and received assurances from its first hand information sources which tended to restrain further action. While acknowledging its lack of awareness of the extent of imprudent practices in CCB, it argued that someone else had the duty to inform it of those matters which were required to be known in order to carry out its own statutory duty. The following quote from the brief of the OIGB deals with loss provisioning practices, but illustrates the tenor of its position in relation to all of the imprudent practices in the bank.

> The OIGB clearly knew that the CCB was deteriorating, but realistically was given no idea from any of its sources as to the true extent of the bank's problems. The auditors reports under s.242 of the *Bank Act* with respect to unsatisfactory conditions, and with respect to their opinion on losses of large loans, appear in retrospect to be incorrect. The auditors and management further failed to communicate a sense of the seriousness of the bank's problems on the inspection visits. These problems were further not communicated in the financial statements directly, nor by way of a note regarding unusual valuation policies.

Thus the triangle has become a self-absolving cycle wherein each member of the group of three might fail in some aspect of their duty, but nonetheless all is considered to be cured by the fact that the next person on the cycle committed a sequential and perhaps even greater breach of duty. The public is left to circumnavigate this circular chain of authority only to end up where it started; without very much protection in those cases where they need it.

Is this a reasonable interpretation of the pattern of regulation, corporate governance and audit functioning prescribed by the *Bank Act* in the provisions that have already been discussed in detail? The question cannot be answered in the affirmative, at least as regards some of the players on the field. The auditors, as discussed above, did not apply the standards and principles set forth by the trilogy of expert witnesses. They enslaved themselves to management decisions by a very narrow and comfortable interpretation of the principles of an auditor's responsibilities. It is necessary to conclude from all this that an auditor's restrictive interpretation of his role and an expansive interpretation of the role of management, including the directors, and of the role of the regulator, cannot exonerate the auditors for their failure to adhere to the principles of bank auditing as accepted in the profession when deciding whether or not to certify unconditionally management's financial statements. Because the financial statements as prepared by management for the fiscal year 1984 and probably for the fiscal year 1983 were not prepared in accordance with those accounting and auditing principles and practices pertaining to the audit of banks as described in the evidence by the experienced bank auditors in their appearance before this Commission, those statements did not fairly present the financial position of the bank at the end of fiscal year 1984 and probably did not do so at the end of fiscal year 1983. Accordingly, the auditors should not have issued their certificate of approval for these statements for 1984 and probably should not have done so for 1983. This is in essence the only function an auditor is called upon to discharge (apart from direct reports when requisitioned or mandated by the *Bank Act*) and in this function the CCB auditors failed. It is also clear from all the evidence that the auditors should have reported to the Inspector General as required by s.242(3) and (4)of the *Bank Act* on the conditions which they found to exist in the bank by the end of fiscal year 1983, and certainly by the end of fiscal year 1984. That section (already set out in Chapter 3 is for convenience repeated here) provides in part:

> (3) It is the duty of the auditors to report in writing, individually or jointly as they see fit ... any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification, and without restricting the generality of the foregoing, they shall as occasion requires make a report ... with respect to
>
> (a) ...
>
> (b) loans owing to the bank by any person the aggregate amount of which exceeds one-half of one per cent of the total of the paid-in capital, contributed surplus and retained earnings accounts of the bank, in respect of which, in their opinion, loss to the bank is likely to occur. ...

> (4) ... the auditors shall, at the time of transmitting the report to the chief executive officer and chief general manager, furnish a copy of the report to the Inspector.

It must be observed that this forum is, of course, not directly concerned with the resolution of the issue as to whether the auditors, or any of them, were in breach of a duty owed to anybody with respect to the events which have been investigated here. The sole function of this Commission of Inquiry is to determine the causes of failure of the two banks and to make recommendations with reference to any applicable laws or regulations or practices which might improve the situation in the years ahead. Therefore, this Commission expressly refrains from making any finding as to the violation of duty, if any, owed by the auditors to persons who have participated in these hearings or to any other persons. It is sufficient, therefore, in the discharge of duty of this Commission, to conclude, and on the record here such conclusion is unavoidable, that had these auditors applied the principles of bank auditing as enunciated in the record before the Commission, the financial statements for the year 1984, and probably 1983 as well, would not have been approved by the auditors. CCB would have been insolvent, and identified publicly as such prior to 1 September 1985. The financial statements of fiscal year 1984, if prepared in accordance with the policies of accounting and bank auditing principles to which reference has already been made, would in all likelihood have disclosed that the bank was insolvent at that time in the sense that it would have had a negative net worth.

All this is said with reference to the information compiled publicly by the Commission. It may be that another forum, not as free as a Commission of Inquiry to receive information from all sources, would be faced with a different record. The above conclusions are reached entirely on the basis of the record here without any attempt to ascertain what the result might be if other rules or processes applied.

4. The Inspector General

The position of the Inspector General in this picture can best be discerned by commencing with the statutory root of his power in s.246(2) of the *Bank Act*, which provides in part:

> The Inspector ... shall make or cause to be made such examination ... into the business and affairs of each bank as the Inspector may deem to be necessary ... for the purpose of satisfying himself that the provisions of this Act having reference to the safety of the interests of the depositors, creditors and shareholders ... and other provisions of the bank are being duly observed and that the bank is in a sound financial condition ... and shall report thereon to the Minister.

This statutory authority has existed for over 60 years. The current Inspector General interprets "his principal role as one of 'prudential supervision', primarily ..." into the two areas mentioned in the above statutory excerpt, namely the protection of creditors and depositors and the maintenance of the health of and confidence in the banking system as a whole.

The OIGB was established shortly after the establishment of the twin auditor system. The system did not contemplate that the Inspector General would examine the loan portfolios in each bank. The very size of the establishment would indicate the extent of the examination contemplated by the statutory structure. By the time of the bailout the staff consisted of 33 and included 7 in the Inspection Division. These 7 inspectors were by statute called upon to make an annual inspection of each of the 72 banks in existence at the peak after the 1980 *Bank Act* amendments. Bearing in mind that an external audit consumed about 300 person auditor days in CCB in 1984, it can readily be seen that the statutory program mandated by Parliament contemplated something considerably less than the equivalent of an external audit for each Schedule A and Schedule B bank. Nothing much in fact seems to have changed since the explanation given to Parliament in 1923 at the time the office was established when it was contemplated that the Inspector General "would be able to obtain from studying reports of the inspectors of the banks [presumably the internal inspectors], the credit information files and also the reports of the shareholders' auditors" sufficient information to "view the situation comprehensively". Four or five years after the incorporation of CCB and Northland, the new *Bank Act* authorized the establishment of Schedule B banks and some 60 of them came into being in 1980-82. No provision was made in the Act for an enlargement of the inspection system or for any adjustment or realignment of that system to accommodate these new banks. The government of the day somehow overlooked the evident need to make some adjustments to the Act to accommodate the changing circumstances in banking and in the inspection and regulation of banks. In short, the adoption of a policy of expansion of the population of banks was not accompanied by a study of the complementary changes required in the supervisory system. It is also notable that the Inspector General (as mentioned in Chapter 3), in an appearance before the House of Commons Finance Committee in 1982, stated that the staff of the OIGB was too small to cope with the increasing number of banks entering the system as allowed by the 1980 revision of the Act. On the same occasion, he expressed the view that the existing staff was sufficient to monitor adequately the general health of the banks although it would be "extremely difficult" to do so.

The latest comprehensive review of the banking system was conducted by the Porter Commission in 1964. The Commission did not devote very much of its examination or report to the inspection system, but it did state that the OIGB should rely heavily on self-regulation by the banks and should continue to rely upon the external auditors. It was a reaffirmation of the so-called tripartite prudential supervisory system. In more modern terminology the Assistant Inspector General, Macpherson, stated:

> ... moral suasion has some value in this whole system. That is the way the system has been for a long, long time.
>
> Q. Well, this is not a matter of morals is it?
>
> A. Well I never stopped to think about the precision of the language in that phrase, moral suasion. But if you would prefer the wink and the nod approach, then I think we still hope that that works and I think it did in this case [a reference to a loan].

Macpherson continued by stating that the enforcement by the "wink and the nod system" was but one string on the bow, the others being:

> ... The one sanction authority that we now have, really, is the ability of the Minister to direct a bank with respect to the levels of its capital and the levels of its liquid assets. That was put in the Act in 1980.
>
> Prior to that there had been nothing. Somewhat hopefully or perhaps naively, you might say, we thought that that was a very powerful weapon indeed in that if we did not like what a bank was doing, we could say, 'all right, we can't stop you from engaging in that sort of practice, but if you do follow such practices, you shall have certain levels of liquidity or certain levels of capital'. The only problem with that is, especially when you are talking about capital, is being able to see it through. If you are dissatisfied with a bank's level of capital, for one thing, the bank may not be able to increase its capital. If it cannot do that, the only alternative is to shrink its size, and that is something that will not occur over night either. So, it is not what we had hoped it would be, but that is really the only statutory sanction that we have at the moment.

Robert MacIntosh, speaking for the Canadian Bankers' Association, took a different view. The CBA considers that the OIGB had all the powers it needed even in the present circumstances and that there was no case for an increase in the regulatory powers.

> Moreover, the Inspector General and the Minister of Finance already have a broad range of powers at their disposal to correct problem situations, for example, moral suasion. To date, moral suasion has been an effective regulatory approach but is by no means the only one available to bank regulatory authorities. The Bank Act provides the Minister of Finance and the OIGB with the following comprehensive powers for the inspection of banks and for the application of remedies in unsatisfactory situations. ...

The criticism of the OIGB by the CBA went more to the need for a more expert staff who would have a familiarity with external market forces and their implications.

The basic procedures adopted by the OIGB have been detailed in Chapter 3. It is sufficient to state here by way of summary that annually the Inspector General makes a request to each bank prior to the annual inspection for data and information sufficient to enable the staff to analyze the various operational areas of the bank. Once this data and the data regularly received throughout the year from the bank is analyzed, the staff prepares a list of its specific concerns and communicates these to the bank. The annual on-site visit by the inspection staff is then undertaken and occupies from a day and a half to two days. In this inspection the bank is analyzed on the CAMEL system, standing for Capital, Assets, Management, Earnings, and Liquidity. In the view of the Inspector General this enables the inspection staff to assess the overall health of the bank and to focus upon the concerns identified in pre-inspection analysis or during inspection. It should be emphasized that specific loans may be reviewed by the inspection staff and may be discussed with the bank but the inspection team does not conduct an examination of the individual loan files comprising the loan portfolio.

As has been seen, the Inspector General takes the fundamental position that he is not only entitled to, but that by statute it is contemplated that he will rely upon, the external auditors and their report on the financial statements of the bank. Lord, speaking for the auditors of CCB, took quite a different position. He acknowledged that the Inspector General "communicates with us and we communicate with him. But his procedures are presumably directed to fill his responsibilities and ours are directed to the financial statements and the specific reports from us requested by the OIGB". On the other side of the issue, Grant stated that without full detailed knowledge of the files in question, the Inspector General is in no position to challenge any particular action by management.

> In discussing this with the bank it might very well have become evident that these were reasonable situations. We left these matters, sir, to the auditors of the bank. ... We depend to a very great extent on the external auditors to provide us with the comfort with respect to the quality of the bank's loan portfolio with respect to its accounting practices.

At least prior to 1980 there were very few banks in this country, all but a handful of which were very large, very strong and very successful on an international scale. A supervision system was required, perhaps, only to ensure the continuance of competitive practices in the banking system and an overall control of what the public interest required of the banking industry in the international field, in specific lending areas such as mortgages, and in the sense of ensuring that the banking system was at all times harnessed to the public interest. Little purpose would have been served by a detailed regulatory audit of the loan portfolios of these large world-scale banks. With the advent of the new banks in the mid-1970s and the Schedule B banks authorized by the 1980 amendments, the picture and the need for supervision changed. The *Bank Act* of 1980 took none of this into account.

This is the simple picture if the OIGB knowledge or awareness is as limited in the case of each bank as the above excerpt from the evidence might indicate. Different considerations of course apply if the OIGB had actual detailed knowledge of the strategy employed by CCB management in attempting to lead the bank to survival and prevent intervening insolvency. The documentation and the evidence given by witnesses reveal a considerable flow of information between the auditors and the OIGB, and a large number of contacts between the two agencies over and above the annual inspection. Indeed, the exchange of information involved a great many contacts between the OIGB, CCB management, the directors, the external auditors, other sources in the banking system, and U.S. regulators involved with the CCB subsidiary and agency in California. There can be no doubt that the OIGB was very well informed about the worsening position of the bank through the years 1982 to 1985. The OIGB's response to all this evidence can be expressed in five propositions:

1. By reason of the knowledge in the OIGB that the position of the bank was worsening, it had the bank under close supervision.

2. The OIGB knew that:

    (a) CCB was aggressive in its income recognition program;

    (b) The loan loss provisioning practices of management were far from conservative; and

    (c) CCB was in all these practices predicating its actions and rationale on the adoption of a policy of attributing to its loan assets "future valuation", but the Inspector General "did not really have an impression of how significant some of these practices might have been in the loan portfolio as a whole". Eventually the Inspector General, after a long presentation spread over the entire hearings of the Inquiry, took the position that in any event these concepts of future value would be employed only over a relatively short period of time after which CCB would be required to make provisions to reduce the face value of the bad loans to something approaching current market values.

3. The OIGB relied almost entirely on the auditors' inferred approval of the loan portfolio as assessed by management when they certified the financial statements without qualification. So long as this condition continued, the OIGB submitted it was inappropriate for the regulator to move in and close the bank.
4. Only by reason of evidence brought to the attention of the OIGB after 14 March 1985 did the OIGB realize that the actual position of the bank was worse than represented by all these sources.
5. The OIGB does not believe that there was anything that it could have done differently except that, with the benefit of hindsight, a cease and desist power (had it existed) could have been exerted to force the bank to take write-offs and reverse accrued interest taken into income, all of which would have closed the bank earlier.

Some insight into the regulator's view of the position of the bank, and the position of the public regulator in the public interest, is gained from some of the evidence dealing with action and inaction by the OIGB. By early 1985, the knowledge of, and the position taken by, the OIGB was described by Kennett:

> Clearly, the conclusion is that the bank is struggling, that its earnings are marginal and that it needs close supervision ... But in fact, for one reason or another, a bank ends up with a difficult portfolio, a portfolio that is full of trouble, there is no magic that will make it disappear. ... We were in a difficult situation. The bank still had adequate capital. There seemed to be a buffer there and that was adequate to handle the problems we understood were there at the time, and that gave us that consolation.

The view of the Inspector General of the aggressive stance of the bank which was evident by 1985 at the latest is revealed by the following questions and answers:

> Q. So whenever they are not paying interest you cannot capitalize?
>
> A. That depends on the value of the security, if there is lots of security there. But at that stage you should be valuing security on a very conservative basis.
>
> Q. Liquidation?
>
> A. Yes.
>
> Q. When did you learn that they were not doing it that way?

> A. We were aware from time to time of individual circumstances that concerned us. The record is, I was going to say, riddled with questions about individual cases, matters of concern to be raised with the auditors, representations of concern from the auditors themselves, and discussions we had with the bank urging conservative practices on them.

He then went on to describe some of the instances where these practices had come to the attention of the OIGB through meetings with managers, auditors, and others, and led the Inspector General's staff to urge conservative practices on management:

> But from our perspective, these were exceptions, if you like, that had come to our attention because of their size or because of their uniqueness. We were never in a position to scrutinize the loan portfolio as a whole to determine how [widespread] these practices might or might not have been.

As to the employment of baseline value in determining the value of the loan portfolio the Inspector General testified that this matter had come to the attention of his office at least in the month of May 1982 in a meeting with the auditors. His evidence in part on this point is as follows:

> In instances where the bank and the clients, as I suggested before, are operating on a going concern basis, the security may be viewed on the basis of some kind of an intrinsic value that may not completely reflect full market value.
>
> My feeling about that is that that kind of situation should only prevail for a relatively short period of time, that where there is a clear gap between whatever value seems to be reasonable for the security over a period of time and the market value that one would expect, as time went by — and I'm talking about quarters not years — that, if that gap did not narrow as a result of increasing value of the loan or the security, that the gap would diminish as a result of write-downs or provisions being taken on a loan. So I would not expect that the gap would prevail for a very long period of time.

It was the view of the Inspector General that the great awakening occurred with the release of the Hitchman Report. The Inspector General described that event in this way: "Well, I suppose the evidence that we found most disturbing was the Hitchman evidence". The detailed information reported by the Hitchman examination coincided apparently with a number of isolated or individual instances known theretofore by the Inspector General: "... but we did not really have any impression about how significant some of these practices might have been in the loan portfolio as a whole". The Inspector General consistently fell back upon the opening proposition enunciated earlier in this section:

> We do not audit banks. We never have audited banks. Essentially, the fairness and accuracy of the financial statements is in the hands of the management of the bank itself and is reviewed by the auditors of the bank and certified fair by

> the auditors. We have had good working relationship with these people we have discussed these kinds of problems with them. We were generally satisfied that the process was working.
>
> . . .
>
> ... we were finally resting on the accuracy of the financial statements and the results of the audit.

From all of the information obtained during this Inquiry, the Inspector General ultimately concluded:

> Assuming those facts, clearly the auditors are going to have to be a lot tougher in the practices they find acceptable and in the review of security values and I think that is happening. ...

Perhaps the reason for inaction, or more fairly put, lack of intervention by the regulator during 1983 through early 1985 can be found in the following statement by the Inspector General to the Inquiry:

> But, finally, we were hoping and expecting, as the bank was and as other observers were, that this economy would turn around and the problems finally the most severe problems, would be short-lived. It turned out that the economy did not turn around.

During this period of hope and indecision perhaps induced thereby, the frame of mind of the regulator was revealed in the Inspector General's statement in evidence:

> Through that whole period the bank was generally adequately capitalized. ... The earnings in 1984 became very spotty, small earnings or slightly in the red but, once again, while clearly a difficult situation and clearly a situation that we were watching very closely, not one that in our view warranted the closing down of the bank. It would have been completely unjustified on the basis of the information that was before us and before the public.

Indeed, because of its fundamental position of reliance upon the external auditors, the OIGB were in their view not even justified in invoking the authority in the *Bank Act* to enlarge the audit of the bank. The Inspector General stated:

> Certainly, as far as we knew, the audit was a federal [full] audit and it never occurred to us that a further audit in the normal course of events of this bank was necessary. ...

It would be incomplete and unfair not to take the picture as projected by the Inspector General in his testimony to its conclusion. In hindsight, the Inspector General concluded that his office could have used a cease and desist power to bring about earlier conservative accounting treatment of some of the operational decisions and actions taken by the banks in the field of income recognition and loan loss write-offs. He continued:

> I think that if we had known more about the loan portfolio in detail and the lending practices in those earlier years, we might have disapproved of some of those practices, but we were looking at the bank and measuring the lending activity in a macro-prudential sense and because of the economic circumstances, which I have described previously, even where their lending practices might have been high risk, the problems were not emerging because of inflation.

Given the rapid rise to success of the bank during the mid-1970s and early 1980s, and given the long period of banking stability in this country, some of these conclusions cannot be said to be illogical or out of order. What remains surprising, however, is the fact that McLaughlan's revelations in Ottawa on 14 March clearly took the Inspector General's office by surprise, and caught them off balance and largely unprepared for the crisis that unfolded.

Two things stand out in the position and in the actions taken by the OIGB in the eleven days from 14 March to 25 March, 1985. First, the OIGB took some time to realize that a thorough check had to be made on the loans proposed for inclusion in the support package by management to ensure that the write-offs proposed by management for those loans were adequate, and on the balance of the loan portfolio to ascertain whether management was proposing a sufficiently comprehensive act of financial surgery in carving out of the loan portfolio the loans as proposed. Second, the OIGB, either by reason of institutional inadequacy or by breakdown in the functioning of key personnel, failed to link the information already at hand in the OIGB with the information flowing in from Edmonton from the loan examination processes taken during the 11-day period, so that the participants in the Support Program meetings could exercise their judgment as to whether to enter a rescue program, and if so, to establish the appropriate scale according to the latest and best information which was then available. These two salient features stand out above the rather chaotic scene which unfolded in the days leading up to the 25 March announcement. A third difficulty which flowed from the bailout, and some of which must be attributed to the OIGB, is the failure by its staff, as well as the Department of Finance staff, the Bank of Canada, and even perhaps the representatives of the major Canadian banks, to appreciate the short- and long-term significance of the wording adopted in the press release as approved by all parties (with the probable exception of the representatives of the major banks). The reference made to the "strong condition of solvency" of the CCB in combination with the Bank of Canada assertion that it would advance such moneys as needed or necessary to meet any liquidity problems, eventually and inexorably led the Government into the need to seriously consider a universal compensation program involving payment to all depositors of the bank, insured or uninsured.

From the extensive record gathered in the Inquiry and summarized in Appendix C, certain things have become evident. It is clear that the OIGB was aware, or had the means of becoming aware, that the CCB over the years, including as a minimum, 1983, 1984 and early 1985, had seriously augmented its income by including accrued interest and by capitalizing interest, had neglected to make adequate specific loan loss provisions, and had employed workout strategies on a wide scale to forestall lowering the classification of a loan, or to otherwise defer or avoid the taking of specific provisions. All these measures were predicated upon a liberal policy of determining that the principal and interest in question were, in the opinion of management, collectable, and on the adoption of future values in assessing the underlying value of the security held by the bank. Left to itself, bank management may be sorely tempted to cross over the boundary of appropriate accounting treatment in order to maintain, through synthetically enhanced income statements and protected balance sheets, the confidence that, in banking, is essential for survival. An inspection system which tolerates or ignores the operation of these practices by management, whether other elements in the system such as auditors perform their role or not, must accept a measure of responsibility for the development of the condition which culminates in bank failure. Should circumstances excuse the regulator from responsibility for the development of the causes of bank failure, there still remains the question of responsibility for failing to intervene and terminate the bank's operation as soon as such condition could or should have been detected. The courage to fight off oncoming insolvency is commendable but surely not in those instances where to do so is simply to prolong the existence of the bank to the serious detriment of those such as the investors and creditors who deal with it. An inspection service which allows management the latitude required to cross over the line must, in appraisal of the efficacy of the total system, share responsibility for the result.

The management of the bank was well aware, on the record before this Inquiry, of the need to overcome the reluctance of the auditors and the OIGB to accept the accounting treatment assigned to all these actions by management detailed above. Management was also aware of the need to avoid rejection by the regulators of prospectuses filed by the bank for the purpose of making an issue of securities to the public. The workout strategies became, in many instances, a device to avoid the reclassification of a loan in order to present a picture of the financial position of the bank as very much healthier than its true position, as known by management to exist. Fee-driven lending practices of management fall into the same category. Auditors' repeated and prolonged acceptance of practices designed to maintain income and shield asset values, and the regulators' silence in the face of their awareness of these practices, unhappily had the effect of leaving management free to prolong the application of these improper policies. As the information rolled into the OIGB regarding the sinking condition of the bank and the practices employed to forestall this trend, the OIGB expressed concern. The concerns expressed, the action taken, and the occasional skepticism about the wisdom of the bank's strategies expressed by OIGB officers are detailed in Appendix C. The question then becomes, what should the Inspector General have done?

At the very least, the Inspector General should have brought these practices to a halt by a statement setting out the proper policies to be followed in the valuation of assets so as to enable all the banks to account for the impact of the recession on the same basis. The Government of Canada did so by Order in Council in September 1931, under which the banks were allowed to maintain stock values at market prices that had prevailed several months earlier. This was a recognition by public regulators of the transitory nature of the sudden and very near complete collapse of stock market values in 1931. Alternatively, the Inspector General could have defined clearly the time limit for projected value expectations, and the time limit for their maintenance at such levels by the bank. This may have had an unfortunate side effect in the money market, both here and abroad, but no consideration was even directed to the problem. Any such course of action, if adopted by the Inspector General, would have required a state of preparedness on the part of the OIGB to bring about a termination of the bank in the event of subsequent noncompliance with such direction. All this has nothing to do with the failure of the auditors to perform their designed function and discharge their responsibilities according to the principles of their profession. Nor was there any impediment to such action by the Inspector General because of a shortage of inspection staff. The information was at hand in the OIGB that the bank was in poor condition and drifting into worse. The Inspector General was aware of the variety of the inappropriate actions being taken by management as already described. The Inspector General was on notice and had all the means necessary to determine the scale of those practices. Perhaps most serious of all was the approval granted by the Inspector General to the issuance by the bank and its fiscal agent of a prospectus inviting the public to invest in the bank when it had been classified by the OIGB as being in "unsatisfactory condition", and when it was known that its financial statements were distorted as to both assets and income by reason of the many practices of management already enumerated. It comes down to the fact that the OIGB either knew and accepted these survival tactics in the bank and failed to respond, or did not know because of a complete failure to recognize the clearest signals. It is a choice of losing alternatives.

All this relates to the 1983 and 1984 fiscal years. The failure of the OIGB in its regulatory responsibilities in CCB must go back to and include the Inspector General's allowance of the expansion of the loan portfolio by the bank in 1981 and 1982 in the face of the advent of a serious recession in its principal areas of operation. This occurred at a time when CCB was still a small and regionalized bank which was already showing symptoms of serious difficulties. The OIGB did nothing to rein in this growth, and to bring about a consolidation of the position of the bank until loan losses encountered from the first onset of the recession could be absorbed, and economies of operation effected.

The OIGB had an installed and functioning early warning system. All the key indicators of trouble flashed on. There was not a lack of awareness or information, but an apparent lack of will to act. The OIGB in its final submission places the responsibility for this inaction on a failure by the auditors to perform their role. The magnitude of the degree of this reliance is dramatically revealed in the evidence relating to a complaint made to a law enforcement agency concerning certain practices in CCB. The essence of the complaint was that management had directed the bank staff to introduce for improper purposes the asset valuation process already discussed. The law enforcement agency attended at the OIGB, revealed the complaint, and inquired as to the position of the Inspector General. In due course, the OIGB advised the law enforcement agency that, inasmuch as the financial statements for the year in question had been approved by the external auditors, there would be no reason for anyone to investigate the adequacy of the asset valuation process. The OIGB did nothing to investigate the matter and did not advise the auditors of the complaint. Nor was legal advice taken. The unbounded reliance upon others is a denial of any role in the regulator. This, coupled with the performance of the regulator in approving a prospectus, reveals an institutional fault, at least, which produced a lack of will to regulate the system where supervision has revealed the need, even if it may lead to a bank closure. As will be seen in Chapter 6, the Commission considers the condition was at least in part the product of the inadequacy of the institutions and their arrangement in the supervisory system.

5. The Bank of Canada

The involvement of the Bank of Canada in CCB's times of need dates back to early 1983 when the Governor assisted CCB in arranging the liquidity support required to bridge the run of deposits occasioned by the Trust Companies Affair. Of particular interest is the role played by the Bank of Canada in bolstering confidence in CCB in the market. It was the Governor of the Bank of Canada, not the Inspector General of Banks, who at that time contacted various news agencies to assure the public that CCB was sound. The following press release was issued by the Bank of Canada:

> ... in response to a number of enquiries concerning the Canadian Commercial Bank which arose following the annual meeting of that bank in Edmonton yesterday, Gerald K. Bouey, Governor of the Bank of Canada, stated that the Canadian Commercial Bank is a solvent and profitable bank and if it requires any liquidity support, the Bank of Canada will provide it.

It is apparent that the representations contained in the release about CCB's condition were provided to the Governor by the OIGB. As has been seen, the perceived position of the Bank of Canada again had a role to play in the events surrounding the bailout of CCB.

The Bank of Canada, partly by the predominant position accorded to it in legislation and partly because of the way it is perceived by the other institutions in the banking system and by the public at large, found itself in an invidious position in the events surrounding the collapse of CCB. The Governor of the Bank of Canada was seen as the leader of the banking system. Naturally, therefore, he was looked to for leadership in this time of crisis. Indeed, it was taken for granted by all participants that the Governor of the Bank of Canada was the appropriate person to preside over the 22 and 24 March meetings to determine the fate of the CCB. Unfortunately, the Bank of Canada is not clothed with the necessary statutory powers or staff to select the appropriate program in such circumstances and to guide its performance. The Bank of Canada is the lender of last resort, the provider of liquidity advances where required by the chartered banks. In a press release issued by the Bank of Canada on 18 April 1985, this succinct statement was made about the position of the Bank of Canada in the system:

> The Governor noted that it is the role of the central bank to act as an ultimate source of liquidity for Canadian banks, and he reiterated that the Bank of Canada stands ready to provide the Canadian Commercial Bank with whatever amount of liquidity it may require.

When the Bank of Canada makes liquidity advances it does so on security taken from the beneficiary bank, usually in the form of an assignment of part or all of the loan portfolio. In this case, the Bank of Canada took an assignment of a loan portfolio of about $2B. It conducted no detailed inspection of the assets in the loan portfolio to determine the strength of the assigned security, though the Comptroller of the Bank of Canada did examine, in a cursory way, along with internal legal counsel, the general state of the portfolio and the form of assignment proposed. Governor Bouey testified about the taking of this security that:

> We would normally have expected to work through the Inspector General; we would not expect to set up a separate or competitive inspection system.

The actual state of the Bank of Canada as the holder of security is somewhat difficult to describe with precision. First of all, the Comptroller, Mr. A.C. Lamb, stated:

> While we can rely on the Inspector General's office for the broad question of solvency, we must assure that adequate security for Bank of Canada advances has been secured.

He went on to say:

> However, we have not gone to individual lending offices to examine the actual loan security which is referred to in this documentation. Rather we have relied on the audit procedures followed by the external auditors of the bank to assure that the security does in fact exist as reported.

He concluded:

> ... on balance it now appears on fairly adverse assumptions that the bank is not likely to require Bank of Canada advances of more than a maximum of $1.3 billion which would represent 70% of the book value of the security now pledged. Indeed the probable peak is expected to occur by the beginning of November [and] to be less than $1.1 billion. On the basis of our review of the portfolio we have concluded that the existing ... agreement provides the necessary security for the probable level of advances with some margin of safety. If advances were required in excess of $1.5 billion it might be prudent to consider hiring consultants to provide a precise market valuation of the portfolio security. ...

It must be borne in mind that these cursory and preliminary examinations were undertaken prior to any complete hands-on inspection or examination of the loan portfolio by the agents appointed by the Inspector General. When these inspections were undertaken by the Inspector General, the Bank of Canada team which travelled to Edmonton to consider this security made little or no contact with the Inspector General's on-site inspectors. As it turned out, the Bank of Canada advanced in excess of the $1.3B security threshold but no alarm was expressed internally apparently because the Bank of Canada authorities expected to receive further insight into the quality and extent of security from the Hitchman assessment. Should that assessment turn out to be accurate or even conservative, the security held may not equal the funds advanced.

The entire relationship between the OIGB and the Bank of Canada on the subject of insolvency and liquidity advances is far from tight and solid. The Bank of Canada is wholly reliant upon the Inspector General for a determination of the state of insolvency of a bank. Once liquidity advances are made to a bank in a certified state of solvency, the Bank of Canada is again largely in the hands of the Inspector General as to the level of liquidity advances which may safely be made on the available security. The nature of the security in detail is another area in which the Bank of Canada must rely entirely upon the Inspector General. On the other hand, the extent of liquidity advances is a matter wholly within the prerogatives of the Bank of Canada and is not determined by the Inspector General. As we will see in the case of the Northland Bank, when the state of insolvency approaches, there is considerable confusion in this relationship because of the state of the law. Depending on the definition of insolvency the Bank of Canada by its liquidity advances may postpone the event. However, the Inspector General may, by determining that the bank is not "viable", bring about a termination of the liquidity advances. This, in some circumstances, will produce a state of insolvency by most definitions, and this indeed is the reciprocating process in which the parties indulged in order to advise the Minister of Finance of the insolvency of CCB.

Liquidity advances entitle the Bank of Canada to an overriding prior security against all comers. The effect is, as Governor Bouey testified: "The more we lend against security the less is left for other creditors". Where the liquidity advance is employed directly in the reduction of deposit indebtedness, it may not have a serious competitive effect on depositors and other creditors. Where, however, the recipient bank uses the liquidity advances to make loans (a practice which occurred at one time in Northland and which the Bank of Canada and the Inspector General immediately stopped), the position of all creditors of the bank is jeopardized by the prior Bank of Canada lien. The very presence of this prior paramount lien is of course at best a negative encouragement for any new depositors to come forward and place their money in the bank.

A further difficulty arises from the requirement in the *Bank Act* and in the *Bank of Canada Act* for the publication, weekly and monthly, of liquidity advances to banks. The beneficiary banks are identified. This matter is dealt with in recommendations which follow so that it need only be observed at this time that a liquidity advance is designed to promote stability and confidence in a bank, and hence, in the banking system. Where the bank is in and out of cash shortfalls for the retirement of maturing debts, it is a matter of no consequence. Where, as here, the liquidity difficulties are long term, the existence of the advances becomes well known in the financial community, and generally throughout the country, long before the liquidity advances are scheduled or intended to be repaid. It is also important to point out that when fellow members of the banking system come forward to assist a bank in liquidity difficulties, no prior security is accorded to them.

Once the rescue issue arose, the Bank of Canada played a role of receding importance. The very opening observation by the Governor of the Bank at the beginning of the meeting of 22 March that the problem was solvency, not liquidity, relegated the Bank of Canada, from a legal viewpoint, to the role of a supporting player concerned, as it was, solely with liquidity advances, once the solvency of the bank had been assured. Initially, as we have seen, the Bank of Canada rallied the public and private components of the banking system to consider the revelations by the management of CCB. This same type of consultation occurred within the Board of the CDIC where again the Governor of the Bank of Canada presided. The Bank of Canada from the outset strongly favoured a program to save the bank, pointing out the serious repercussions at home and abroad of a bank failure. However, the Bank of Canada, as we have seen, was in no position to lead the discussion surrounding the formation of a rescue program because it did not have the mandate or the staff to provide the management information necessary to design such a proposal, and to advise for or against its adoption apart from pointing out the general effects it might have on the banking system.

Once the participants resolved to proceed with the rescue program, the Bank of Canada was associated with the press release which refers to "the long-term viability" and "the strong position of solvency" of the CCB which would result from the Support Program. The following exchange occurred between Commission counsel and the Governor of the Bank of Canada concerning that announcement:

> Q. Was it appreciated that this would be relied on by people dealing with the bank and if the bank failed later this might involve some liability on the part of the government?
>
> A. I think it is appreciated that the bank would not fail later at that stage. That side of it was not ever ...
>
> Q. You never contemplated that the bank might fail notwithstanding the bailout package?
>
> A. Well I suppose the risk is always there. As you know the banks want to be treated like other depositors in case anything did go wrong. But I think we all felt the bank was viable and viable for a very considerable time. ...

From the testimony received in the Inquiry and from the contents of reports issued by Committees in Parliament, it is clear that the seeds of a requirement to compensate injured depositors originated with this press release and the reliance thereon by the public in general and the financial community in particular. Bélanger, CEO of the National Bank, summarized the feelings of some of those from the big banks who participated in the rescue discussions when he said of the wording of the press release that he had no reason to doubt the solvency of the bank, but as to its "viability", the term may not have been prudent. The Bank of Canada's prestige in the financial world was used to give credibility to the Support Program; and this was perhaps the bank's greatest contribution.

The very limited position of the Bank of Canada in bank regulation and bank rescue is illustrated by the bank's intervention during the Support Program to persuade the major banks to continue their inter-bank credit with CCB. The bank's persuasive powers failed. It had no other power.

The overall position of the Bank of Canada is well put by Governor Bouey from whose speech in September 1985 the following excerpts have been taken:

> In this country the system of bank supervision based on an information network of external bank auditors, internal bank inspection systems and bank managements was designed by Parliament to operate separately from the Bank of Canada and the bank must rely on the judgments that emerge from it.

He continued:

> ... the Bank of Canada ... was not in a position to provide information to that part of the discussions bearing on the condition of the bank and therefore how large the support package needed to be. The judgment about the size of the support package required to make the bank solvent was based on the best information at the time a decision had to be made. And I regarded that judgment as reasonable in the circumstances. The Bank of Canada therefore wholeheartedly supported the effort to save the bank. That is why I stated publicly at the time, and repeated subsequently, that since the bank was judged to be solvent and viable the Bank of Canada would provide whatever liquidity support was required.

The only significant evidence of an active role of the Bank of Canada in the regulatory system was a memorandum of October 1982 from a member of the Bank of Canada staff which revealed something of the impending troubles in the bank. This memorandum was found in the files of the OIGB. The close relationship between the Bank of Canada and the OIGB on questions of supervisory matters is revealed by the important, but unexplained, information given by the OIGB to the Bank of Canada of the impending meeting of 14 March 1985 which the OIGB has described in evidence as a "scheduled" and "routine" meeting with CCB.

Four questions remain unanswered concerning the Bank of Canada and its role in these matters. First, can liquidity advances made under the present statutory pattern in fact promote stability in particular banks and in the banking system? Second, can the Bank of Canada safely and securely advance liquidity moneys to a bank in trouble relying solely on assurances as to solvency and the value of the loan portfolio given by another agency of government, at the present time the OIGB, which does not itself examine and assess the value of the loan portfolio? Third, considering its limited statutory authority and absence of inspection staff, should the central bank be burdened with or take on the burden of announcements concerning the solvency, or otherwise, of chartered banks in Canada? Fourth, is there any merit in considering a combination of the inspection facilities and duties with the central bank as is done in the United Kingdom, and to some extent in the United States? These issues are dealt with in Chapter 6.

6. The Minister of Finance and the Minister of State (Finance)

The responsibility for the administration of the *Bank Act* resides in the Minister of Finance. By administrative arrangement, the Minister of Finance, through two letters dated 5 October 1984, delegated his duties and powers to the Minister of State (Finance). The Department of Finance does not have in its staff persons experienced in or assigned to the supervision of the administration of the *Bank Act* or the operations of the chartered banks. In matters pertaining to the *Bank Act*, the Department relies upon the Inspector General of Banks who has the status of a Deputy Minister and who reports to the Minister of Finance and/or the Minister of State (Finance).

Under the *Bank Act* the Inspector General is required to report to the Minister of Finance the state of each chartered bank not less frequently than annually. The report on CCB for 1984 was dated 24 September 1984 and was directed to the Minister of Finance who received it about two weeks prior to the delegation of authority to the Minister of State (Finance). The Minister of Finance testified that on receiving the report he understood that the bank was in a less than satisfactory condition but that the report contained a "reassuring element". The Minister then had a discussion with the Inspector General which he described in evidence before the Inquiry as follows:

> In general terms we discussed the CCB and the problem with the Western banks. We discussed the general problems with the banking system and concerns about the less developed countries' debt problems. There were no red flags raised. It was more of a discussion to make me aware of the problems that he was aware of and he wanted me to be aware of.

The Minister, prior to receipt of this letter, had the benefit of an earlier transitional briefing session with the OIGB wherein the Minister was advised in part:

> The performances of Northland Bank and CCB remain substandard due almost entirely to the continuing weaknesses in the economies of Alberta and British Columbia.

This was the explanation accepted throughout these events by the Inspector General until the time when the first on-site inspections were received by him in detail and in writing in July 1985.

The briefing continued: "... the difficulties take the form of nonperforming loans which are not being serviced by the borrowers. In the banking system as a whole nonperforming loan levels are at historical high levels." This was the extent of the knowledge of the Minister of Finance of these matters prior to the onset of the rescue discussions shortly after 14 March 1985.

After her appointment, the Minister of State (Finance) met with the Inspector General on the average of once every two weeks and she, of course, was made aware of the issues raised in the briefing material and the Inspector General's September letter to the Minister of Finance. The Minister of State testified concerning her opening briefings on CCB: "... that management was attempting to work out of a difficult economic situation and that the bank was sound, fundamentally sound, and it required monitoring and supervision from the Inspector General's office". That was the extent of the Minister of State's information on this bank prior to the revelations of 14 March.

The bailout process has been described in detail earlier in this Chapter and in Appendix D. It should be noted first that the Minister of State did not attend any of the bailout meetings but relied on the presence of the Deputy Minister of Finance, the Inspector General, and the Governor of the Bank of Canada, together with their officials, to represent the Government viewpoint. Two features surrounding the bailout discussions stand out. First, the executive branch appeared to have adopted a wait-and-see attitude as regards the major banks to determine what role, if any, they proposed to play in these events before determining whether the Government of Canada would favour a rescue program in contrast to a liquidation process, and if the former, would commit public funds. No such decision was in fact made on this essential point until Saturday, 23 March, nine days after McLaughlan's startling visit to the regulators. The second feature which stands out is the inability of the public agencies to mount a quick, comprehensive and authoritative examination of the condition of the loans comprising the loan portfolio, the principal asset, of the CCB prior to the fateful decision to adopt a rescue program on 24 March 1985.

The Minister of State was in charge and consideration must be given to the nature and timeliness of the executive branch's response to this crisis. The primary operational role is, of course, established by Parliament in the Inspector General. The Minister, however, has extensive powers under the statute and is the minister responsible for the Inspector General's office. On the other side of the ledger one must recall that the Minister had been in office only three or four months when these unique events unfolded. Furthermore, the Government was newly installed in office and these events raised issues of far-reaching and fundamental importance. The Minister of State observed in evidence:

> I am essentially a free enterprise soul and you cannot save every institution whole ... We were developing policies as we dealt with this situation.

There were, of course, many alternatives which had to be examined and related facts to be sifted out before the focus narrowed down to a bailout process. For example, the major banks had to be considered as merger candidates which, in the western world, is the route most frequently taken when a bank gets into solvency difficulties. All these things take time, particularly when several agencies in the public sector are involved and when there are at least six members of the banking community to be consulted.

There remains one other feature of some importance in these proceedings. CCB was really not consulted in the bailout process once the major banks were involved. CCB was not represented at the meetings in Ottawa after 22 March except at the first meeting, and then only to make a presentation and withdraw. CCB officers were not present in Ottawa during the formation of the actual Memorandum of Intent leading to the Participation Agreement. Indeed, CCB did not participate as a negotiating party in the Participation Agreement. Once the program had been agreed upon in general, the details were put to CCB on a take-it-or-leave-it basis. This may be an essential method of proceeding because of the complexities and the number of people involved in determining the terms and conditions of a comprehensive rescue program. Nevertheless, the difficulties, examined above, which arose in the formation and execution of the bailout process, were enhanced considerably by the absence of CCB and its fund of information concerning the fine points to be settled.

One might make a number of suggestions in hindsight on actions which could have been taken by the executive branch of Government, but on the whole, considering the novelty of the crisis, the speed with which it landed on the doorstep of Government, the complexity of the necessary arrangements within the banking system for a rescue program, and the recent accession to office of the principal Ministers of the Crown concerned with this matter, it is difficult to reach any critical conclusions of the role played by the two Ministers in the determination of the public policies which had to be settled as a forerunner to the actual Support Program. It is difficult for an observer after the fact to determine whether the Ministers' conduct displayed caution appropriate to their role as custodian of public funds or on the contrary was delay adopted as bargaining "brinkmanship" to induce a contribution from the "Big Banks". There is no support in the evidence for the latter possible conclusion. The Deputy Minister revealed a clear reticence to expose public funds to such an enterprise. The Ministers acted only after the Government itself took this important decision.

The performance of the bailout program raises different considerations. Clearly there was a complete inadequacy of follow-through in obtaining the information necessary to produce the final Participation Agreement and to properly monitor the progress of the rescue program. In particular, the Minister of State appears to have made no effort to press for an early and organized hands-on examination of the loan assets of the bank. Many efforts were made by the OIGB on what appears to be a spasmodic and hit-or-miss basis, and communications of the results, commencing with the examination of 20-21 March and continuing through until the Hitchman Report, were not effective and immediate. The Minister of State (Finance), when faced with a very clear demand in mid-June from the major banks, did organize through the Inspector General the appointment of Hitchman and his team to examine the loan portfolio on site. This report was received in interim and final form by the Minister of State although she did not personally interview Hitchman when his work was completed to assess his mental picture of the financial health of the bank in mid-August during the rescue program.

There are surprisingly few documents, reports, memoranda and minutes of the action taken by the ministerial staff and by the Minister of State (Finance) during the period from 25 March to 1 September. The Department looked to the OIGB as the administrative arm to guide the bailout process. This stands in sharp contrast to the detailed picture available in a comparable rescue program in the United States in 1984. In that program, provision was made for a second phase not unlike the formal Participation Agreement here, except that the second phase was a reconstituted program redesigned in the light of information coming to the surface after the initial bailout process had been inaugurated. The financial arrangements were retuned in this second phase and it really represented a new rescue endeavour based upon the facts then known. Here, the rescue program once designed stayed put. There was no reevaluation of the adequacy of the $255M infusion, no attempt made to clarify the status in law of those moneys or the respective rights and obligations of the parties to the program, and as already seen, a very slow examination of the principal assets of CCB. The bailout program seems to have been conducted more like the launching of a toboggan. Once it was placed on the slope its course, speed and destination were left to gravity and the toboggan. There was no steering mechanism and no machinery for change of direction or increased financial support or indeed any other adjustment, whatever risk may loom up. But this must be a critical observation on the performance of the Inspector General upon whom the Ministers were clearly entitled to rely. The Ministers gave the officials adequate guidance and support and properly left the execution to the administrators.

The precise instruments for the measurement of the bank's health were only installed in late August, and then only for the purpose of determining the extent of solvency. All this is somewhat difficult to comprehend given the clear press announcement which in essence stated that the Government would stand by this bank and see that it did not fail. By 8 July, the Minister of Finance had been advised: "There is sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now". The record is silent, however, as to when these preparations were actually put in train. The Inspector General's evidence was that:

> We were actively seeking other alternatives and by August 13th we were beginning to plan for the possible liquidation of this bank ... You simply do not wake up one morning and decide that today we are going to close the bank. There is a lot of preparation that needs to be made, and you want to make very sure that you are not making any mistakes about that, that the evidence is indisputable and that the alternatives have been adequately canvassed.

By 23 August the Inspector General had eliminated the possibility of merger and was narrowing the alternatives down to the form of liquidation, that is the appointment of a curator or of a liquidator for the ultimate wind-up of both banks.

In the dying days of the bank, the treatment to be accorded uninsured depositors emerged as a key issue amongst the participants in the support group, particularly, of course, the public officials. The combination of the lack of information at the time the rescue program was adopted and announced, and the tenor of that announcement and subsequent statements by the Ministers made in the House of Commons shortly after the 25 March announcement, boxed the Government into a position where the only defensible alternative was universal compensation of creditors of the bank. The most serious comment to be made concerning this issue is the lack of awareness of the consequences of announcing a rescue program and particularly on the terms set forth in the various announcements starting with that of 25 March 1985. Again one turns to the experience in the United States where the public authorities first determine whether the ailing bank is "an essential bank" and if it is, a bailout or rescue program is initiated, usually in stages. In the course of this type of program, the public authorities make a clear unqualified announcement in which an assurance is given to the world that this bank will not fail. Unhappily, the case of the CCB was a hybrid. An announcement generally to that effect was made, but the program was not re-engineered when the required magnitude of intervention was properly assessed several months after the program was initiated. In the end, of course, the program was allowed to fail. Hence the dilemma as to the scale of compensation over and above the limits of insurance coverage through the CDIC program.

There are several items of unsatisfactory "fall-out" from the Support Program which lead to specific recommendations in Chapter 6. One of them is the expensive consequence of universal compensation of depositors above insurance limits which flowed from the lack of statutory and administrative precision in the supervisory structure as it purports to extend to bank support programs. Another unsatisfactory element was the uneven impact of loans outside the depositor class. This refers to the differential treatment which resulted when the Governments of Canada, Alberta and British Columbia bought out the debenture holders, while the participant banks were denied recovery of the $60M they advanced in the rescue program. This is the subject of a recommendation in Chapter 6.

Finally we come to the end of the day when on 1 September the communications set out in Appendix D passed between the Inspector General and the Governor of the Bank of Canada, followed by the Inspector General's advice to the Ministers to appoint a curator under s.278 of the *Bank Act*. From all this it is apparent that the responsible Ministers must, in fact, rely upon the Inspector General for all major decisions concerning the assistance to be advanced to a bank facing problems in insolvency. There is no departmental staff outside the office of the Inspector General qualified in this matter. The Bank of Canada has no statutory role to play beyond the making of liquidity advances where the problem of the ailing bank is a transitory inability to meet liabilities when they fall due.

The relationship established by the statute between the Minister, the Inspector General and the Bank of Canada, with reference to the appointment of the curator, needs a complete reexamination. The Bank of Canada is confined in liquidity advances to payments to solvent banks. The Inspector General therefore must determine solvency of the bank, although the term is not defined in the statute. So long as liquidity advances continue, determination of insolvency is made difficult. The Minister, on the other hand, must in practice await the recommendation of the Inspector General for the appointment of a curator and again a recommendation that an application be made under appropriate statutes for the liquidation or winding up of the bank. All of this must be done on the basis of information available at the time which means that the Ministers responsible are very much in the hands of the professionals in the Inspector General's office. The limits of responsibility in the Ministers must be to install competent persons in the administrative structure and to ensure prompt discharge by those officials of their statutory and administrative duties. Here this principally relates to the Inspector General who had been in office for about 7 years before the Minister of Finance took office. The system beginning with the responsible Minister must rely on the Inspector General, his effective Deputy Minister in the field, for information on the regulation and operations of the bank. By the time government agencies and officials became fully aware of the state of affairs in these banks it was already too late for effective help at a reasonable cost.

The Inspector General as the chief of the supervisory system must be answerable for any shortcomings in performance of the inspection service other than those strictly occasioned by fault in statutory design. Here the OIGB failed to forecast the decline and fall of these banks. Until at least 14 March 1985, there was nothing reasonably evident to warrant any action by the Ministers with reference to these banks, or the structure or personnel of the OIGB. By the time any such matters became apparent, the damage had been done and the banks were for all practical purposes beyond retrieval. Apart from a delay in formulating government policy as to the intervention with public funds in a rescue program of the bank, (which might not have been "delay" but rather may well have been proper caution as earlier mentioned) and apart from a tardiness in directing the OIGB response to the request of the major banks for a detailed and comprehensive loan portfolio assessment, there is nothing in the evidence which leads to criticism of these Ministers.

Chapter 5

Northland Bank: Commentary and Analysis

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Northland Bank: Commentary and Analysis

This Chapter contains commentary on the causes of collapse of the Northland Bank and on the conduct throughout the events in question of the parties closely connected to these events. Appendix E sets out a factual synthesis of the evidence heard before the Commission. Some of the descriptive material is repeated here for clarity and convenience. Many of the institutional issues in relation to various governmental agencies, including the role of the Bank of Canada and the development and philosophy of supervision of the OIGB, in relation to CCB have been covered in Chapter 4. Likewise, the background of the Western Canadian recession has been discussed in Chapter 4. These matters, although equally applicable here, will not be repeated.

A. CAUSES OF THE COLLAPSE OF NORTHLAND BANK

1. Original Concept

Although Northland Bank was the product of philosophies that differed in some respects from CCB, it appears to have been born with several of the same potentially fatal weaknesses embedded in its corporate genes.

Northland Bank was conceived at about the time of the Western Economic Opportunities Conference as a regional bank designed to service the needs of the mid-size commercial and wholesale operations in Western Canada. Its founders considered that the large national banks did not service the small business operations characteristic of Western Canada. This was to be Northland Bank's market niche, and it led inevitably to the establishment of a loan portfolio concentrated geographically in Western Canada and sectorally in real estate and resource-based operations. Lending was to be in the commercial mid-market with loans ranging from $100,000 to $2M, although the latter ceiling was removed in the second fiscal year. In the original descriptions of the bank, the founders announced that it was the intention that the bank should be a "boutique" for business rather than a big bank "supermarket".

As in the case of CCB, there was an identity between many of the directors and the large shareholders. In the case of Northland these were credit unions. An intention to phase this identity out is evidenced by the fact that the bank in its earliest years was listed on the Alberta stock exchange with a view to establishing a widely held bank stock. Initially, it was anticipated that there would be a flow of deposit moneys from the credit union movement. Shortly after Northland was formed, however, the credit unions created a national liquidity management pool for the credit union system, and that source of deposit moneys for Northland Bank dried up. This drove the bank to the wholesale money market very early in its history. Eventually, the bank found the volatility of that market too difficult to live with and accordingly, beginning in 1983, it actively sought retail deposits, showing, as in CCB, a belated recognition of the dangers of the wholesale money market as a source of funding in Canadian banking.

At the outset it was intended that Northland Bank should operate, at least in part, as a merchant bank in the style of the British merchant banks. Such a venture was planned but never launched, although in later years, Northland Bank did develop the business of charging fees for providing lending services in the sense of initiating business transactions and bringing together potential venturers. In the last three years of the bank under the leadership of Mr. W.E. Neapole, the bank had, in his words, developed into a unique combination of a traditional bank and a merchant bank.

Legislators reviewing the proposal to incorporate the Northland Bank in 1975 understood and appreciated the perceived need in Western Canada for regionally-based financial institutions, as the comments of the Honourable Donald Cameron at the second reading of the Bill confirm:

> I think it is evidence of the burgeoning growth of Alberta and western Canada as a whole that there is a widespread feeling that there is a place for another western financial institution.
>
> The concept of a regional bank in the western provinces is not new. The proposed Northland Bank is the latest of a long series of proposals that have been made since the 1960s to the effect that some financial institutions should have their main roots in western Canada. This proposal today is the result of the considered judgement of a number of very responsible and well known business leaders in the four western provinces.
>
> The feeling has developed that there is a place for a new financial institution which will have its roots in western Canada and which will be charged with the responsibility of assisting in the provision of credit, financial advice and other money-related services. This feeling has been confirmed by a number of

> commissions and has been strongly supported over the years by the western cooperative organization whose memberships represent about 1.5 million western Canadians.

Evidence was also presented to the Senate to indicate how the bank intended to operate. Senator Cameron continued:

> ... the bank, through its personnel, will stress imaginative and innovative methods of providing finance to an expanding economy while maintaining the highest standards of accepted banking practices.

The wholesale funding concept was disclosed to the legislators. As in the case of CCB, the Inspector General of the day appeared before the legislative committees to record that he had no objection to the passage of the incorporating Bill. Accordingly, the bank received the blessing of the legislators, exposed as it was to be to geographic and sectoral development and to funding at least in part from the wholesale markets.

It is clear in retrospect that the original design for this bank was fundamentally unsound in that the founders intended to operate principally in the western provinces and in cyclical, relatively high-risk sectors such as real estate and resource development. The bank, therefore, would lack a diversified loan portfolio. The proposed customers were small to medium-sized clients without diversification in their business and without access to the equity markets in their own right. Furthermore, it is extremely doubtful whether an aperture existed in this part of the market by reason of its neglect by the major banks. It is more likely that imprudent and optimistic lending practices artificially expanded or created the market than that the operations of Northland Bank demonstrated that such a perceived market existed. Finally, the wholesale funding plan was a hazardous base on which to build a small regional bank.

2. The Early Period: November 1976 to May 1983

The directors and management of Northland Bank have consistently taken the position that the western recession, induced by a collapse in oil prices and high interest rates, was the basic reason for the eventual failure of Northland Bank. There are other factors, however, which must be examined before one draws any conclusion as to the causes of failure of this bank. Some of these factors have their roots in the early years.

An overview of the management ranks of the bank in the early years indicates that it went through at least three stages. In the first years, the bank was more conservative in its domestic loans. The first CEO, Mr. Hugh Wilson, was knowledgeable in international banking, and accordingly the bank put 50 per cent of its loans out in the sovereign loan field. This strategy was abandoned on his departure in 1979, and sovereign lending gradually diminished to about 7 per cent of the bank's loan portfolio. Wilson was terminated in 1979, and the Chairman, Mr. R.A. Willson, became CEO. This was the second stage and was described by Neapole as one in which "the overall strategy in retrospect was to grow as quickly as possible". The third stage, to be discussed later, was the period in which Neapole served as CEO. In that stage the bank was principally concerned with the development and refinement of survival tactics which have been variously described as entrepreneurial and aggressive. It certainly was not conservative banking.

Overall, the bank's loan assets grew from $27M in 1977 to $510M by the end of the sixth fiscal year. During the same period the capital base grew from $10M to $31M. There is no doubt that in the period ending 1979, apart from its overconcentration in sovereign loans, the position of Northland Bank appeared to be reasonably sound. Its ratio of net income to total assets was good, even higher than in CCB. However, as CEO Mr. Walter A. Prisco observed in 1982: "Anyone who failed in Alberta in those years [1977-1980] must have been outright stupid".

The first crack in the wall appeared with the dismissal of Hugh Wilson. The cause of dismissal appearing in the directors' minutes was "deficiencies in interpersonal skills". He was succeeded as CEO by R. A. Willson, who was to serve as CEO until an experienced individual could be found. Willson adopted an approach to Northland's growth which differed significantly from the slow and steady approach Hugh Wilson had explained to the Senate Banking Committee prior to the bank's incorporation in 1975. Willson distributed a message to the bank's shareholders shortly after his accession to office, which stated in part:

> ... while Northland has moved quickly to establish its name in the international inter-bank family, the Board has felt that our major opportunity and priority lies in rapid penetration of the western Canadian market. ...
>
> The Board has therefore sought to change the style of executive leadership, stressing the building and development of a strong western team, ... It was felt that Hugh's skills were best suited to international banking. While not a banker, I am advised by my fellow Directors the Board's appointment of myself is predicated on my extensive management expertise in Canada and abroad as a senior executive, teacher and consultant, including counsel to other banks in the past.

During Willson's tenure as CEO, loans grew from $82M at the end of fiscal 1978 to $398M at the end of fiscal 1981, with most of this growth being concentrated in fiscal 1981. The bank had begun to emphasize real estate lending in 1979 in part because such loans were easier to put on the books, and by 1980, the bank's attention had shifted to larger loans. Willson's view was that by working within a loan limit of $2M to $3M the bank was finding it difficult to accommodate business needs and to maintain customer confidence.

It may not be without historical relevance to mention the dismissal of the auditors, Touche Ross & Co., who were dropped from the rotation at the end of fiscal 1980. The record indicates that a partner of Touche Ross, D. Heasman, had insisted successfully upon the establishment of a $400,000 reserve on a single loan. Management was opposed and a heated debate ensued at the eleventh hour. There is some evidence that a dispute arose about the same time between the management and the auditors about fees. The Inspector General expressed the view that it was the reserve issue which led to the removal of Touche Ross, and in September 1985, Willson is recorded as having said that Touche Ross had been "fired" as auditor of Northland Bank. Further details are provided in Appendix E. It is a reasonable conclusion that, notwithstanding their status as auditors for the shareholders, the management of Northland Bank effectively controlled the audit appointment and brought about the termination of the relationship of Touche Ross. Reference will be made later to a second management-auditors episode.

Walter Prisco, an experienced banker, joined the bank as President in January 1981. In mid-July 1981, he became CEO. In his assessment, Northland Bank had been run as "a Mom and Pop shop", and was devoid of meaningful policies. He sharply criticized the lending practices. Despite an apparently successful start with Northland, Prisco was discharged in mid-1982 over a dispute concerning the acquisition of a guarantee corporation by the bank and the valuation of a bank loan in the Cayman Islands. While there is no doubt that a power struggle preceded Prisco's departure, it would be of no assistance to this Commission in the discharge of its mandate to attempt to assess the rights and the wrongs in this dispute. In the end, one director (Mr. W. W. Siebens) resigned and another (Mr. K.M. Stephenson) was not nominated for re-election at the end of 1982. Willson again resumed the office of CEO.

Before resigning, Mr. W.W. Siebens commissioned Mr. R. Tourigny, a financial analyst in Calgary, to report to him on the financial position of the Northland Bank. The report is detailed in Appendix E. It was based entirely upon financial information obtained from Siebens or from the public market. It was very critical of the bank's capitalization, the high rate of turnover of key staff, a serious loan loss potential not disclosed in the financial statements, and the bank's overreliance on fee income. This report, written in the late summer of 1982, turned out to be prophetic. It was circulated to the Board and Willson circulated a response.

Mr. K.M. Stephenson, a director, also expressed concerns about the bank in a speech delivered to the Board. Willson testified that Stephenson, who was connected with the power struggle mentioned above, delivered his comments in an abusive fashion. The comments do, however, draw a graphic distinction between the bank's paper position and its cash position.

> Let's talk about results for a minute in very succinct terms. After six years of the Chairman's management of the bank the stock is trading at a little over half of its issue price. The bank's earnings would be in a significant loss position if it wasn't for the mickey mouse treatment of taxes. Tell me any other business where you can book future profits, currently, especially when the same future profits are in substantial jeopardy for a number of reasons, one of which is the loan losses related to loans booked when the Chairman was directly in charge. I don't care what the auditors recognize, the bank simply did not make the money, and we can't spend it.

After Prisco had departed no action was taken by Willson as CEO to undo Prisco's work in the establishment of lending guidelines. Willson was active in examining the practices in Northland Bank as to the treatment of interest income and indeed, in the third quarter of fiscal year 1982 he caused about $1M of accrued and recognized interest to be reversed. The bank thereby suffered in that quarter its first loss. Willson also sought the assistance of a retired credit officer of the Canadian Imperial Bank of Commerce to comment on the lending policies. Apparently a general report was made which revealed no serious problems in the management of the bank.

The turnover in leadership at Northland Bank may illuminate some of the troubles which developed in that bank. In its short history, the bank had four CEOs, at least four executive or senior Vice-Presidents, four internal inspectors and four Vice-Presidents of Credit. Of even more significance is the parade of CEOs. The first CEO, Wilson, served from 1976 to 1979. He was followed by Willson who was not a banker and who served from 1979 to mid-1981. Walter Prisco, an experienced banker, assumed that position in mid-1981 and served until dismissed in mid-1982. At that time, Willson resumed the position and served until mid-1984. Neapole, also an experienced banker, became CEO in mid-1984 and served until the bank was liquidated. The bank was in business slightly less than nine years, for more than half of which it was led by a CEO who had no experience in banking. It surely is not impossible for any given organization in almost any field to be led by a person not versed in that field. It must be equally true, however, that a new organization setting out in the field of banking should be guided by a person with considerable experience in banking. Willson appears to have had a general expertise in business at large, and he was, of course, connected with the bank from its pre-incorporation formative years. Indeed, he helped guide the project through the Committees of the House of Commons and the Senate at the time of the statutory incorporation of the bank. However, he brought no knowledge of banking to Northland Bank's most important position.

The evidence before the Inquiry is replete with references from a variety of sources indicating that early management in the bank was ineffective or worse, and applied imprudent policies. Lucille Johnstone, who joined the Board of Directors in 1978, considered that one element of the bank's weakness was the turnover in the CEO position which was "a disruptive type of situation" and "... it is very difficult to build a team as each CEO comes aboard with his own ideas and preferences in people". In her time, she saw Wilson depart and Prisco come and go. Without tracking the several departures from high executive positions in the bank, it can accurately be stated in summary that the pattern of management turnover may have slackened somewhat in later years, but continued until 1985. The result was that when the recession hit the west in general, and this bank in particular, there was no experienced management team securely entrenched in office. A view of the record reveals a parade of persons including Siebens, Neapole, Prisco, and Mr. M. Mackenzie, an auditor, who stated, sometimes in their own right and sometimes referring to the statements of others, that management of the bank was "weak". Mackenzie stated, "Neapole made no secret to us that the bank had a history of bad management". Neapole himself stated:

> ... the overall strategy in retrospect was to grow as quickly as possible. Internal credit policies were more optimistic than prudent and the general euphoria of the day led to the granting of virtually 100 per cent of the loans that became later problems.

Prisco, in a memorandum dated 8 March 1982, before his troubles with Willson and members of the Board had flared up, stated:

> Our loan problems stemmed from poor judgment, faulty analysis, lack of foresight, and careless monitoring (follow-up) control, i.e. weak management.
>
> . . .
>
> When I arrived here last year what this Bank was, was essentially an asset-based financing [sic: finance] company. ... Not enough attention was being paid by our credit officers to the quality of management, the strength of those to whom we lend to withstand adversity. ...

Northland Bank's credit granting record in its first 5 years of operation has been a poor one, by any standard.

The record reveals that Prisco inaugurated some guidelines on lending practices with which Willson and Neapole agreed although the former expressed considerable reservation as to Prisco's methods. These guidelines condemned practices such as 100 per cent financing and failures by the credit officers to assess the cash flow of security and the creditworthiness of the borrower himself. Whether these guidelines were applied is another question which will be reviewed shortly. By the close of the Willson years, the bank had a domestic loan portfolio of which about 57 per cent was located in Alberta and 25 per cent in British Columbia, and which was concentrated principally in the areas of real estate and energy. Willson testified that such a lack of diversification coupled with the small size of the bank dictated more conservative lending practices. As will be seen, such did not turn out to be the case.

At the close of this period, the bank found itself with many problems in its loan portfolio and a serious absence of experienced bankers in its upper leadership ranks. This condition impelled several commentators, including Prisco, Siebens, Stephenson and Mr. Stan Willy, a Chief Inspector of the bank, to warn of an impending doom. Succeeding management seemed to appreciate the gravity of the situation and directed their energies to the development of survival tactics in the hope of pulling the bank through these serious and perhaps terminal conditions. It is not apparent that the OIGB and the external auditors had a similar awareness, and the absence of that awareness is difficult to explain.

The Commission is driven to the conclusion that the bank suffered greatly in its formative years from a lack of stable and experienced leadership at the top and in the senior levels of management. This management, as earlier discussed, pursued business in a market slot which probably did not exist, in a narrow geographical region, and in cyclical industries. The vulnerability of the bank was greatly increased by a lack of conservatism and prudent lending practices in its operations from 1979 onwards, and by its reliance for funding on the wholesale money market.

3. The Neapole Years: May 1983 to 25 March 1985

a. Development of the Strategy

There can be no question on the evidence that Northland in 1983 was facing very substantial financial problems. The evidence is abundant. Mr. M. Fortier, who became a senior Vice President in 1983, was "shocked" at the state of the loan portfolio. The internal inspector, Mr. Iain McLeod, who joined Northland Bank in September 1983, described the loan portfolio as a "time bomb". Indeed, so overwhelmed was he by the condition of the portfolio that he tendered his resignation in his first week and had to be persuaded by Neapole to return and help salvage the situation. Neapole himself stated that the loan portfolio was "having difficulty".

The evidence of Neapole is the most instructive source on the conditions existing in the bank in 1983. The bank was at that time faced with a large number of nonperforming loans so that, in the words of Neapole, "The fundamentals of the income statement ceased to make any sense". He was acutely aware that he needed to somehow obtain the time to improve the portfolio and repair the damage that had been inflicted upon it. In this critical condition he acknowledged the importance of market confidence, and that the bank could not afford to suffer a loss. He stated in part:

> There is no question that the market awaits your financial results from time to time. Obviously good news is better than bad news.

It was therefore necessary to devise a workout strategy. Neapole and others described in varying ways the dominant purpose of the cohesive strategy which he and his fellow top management had adopted in these circumstances. The dominant purpose was to undertake an asset management program which would, by various methods of workouts, add value to the problem loans and the security held by the bank, so as to postpone their liquidation, maintain confidence in the bank, and thereby enable it to survive until the damage in the loan portfolio could be repaired. Often expertise from the industry in question was sought to complement the bank's own resources in the workout of problem loans. A phrase common in all this testimony was "managing the bank's income statement". This included, in Neapole's understanding, controlling the taking of specific provisions against losses. Associated with that activity was the need to bring about growth of new loans in the portfolio so as to dilute existing problem loans. The upshot of all this was that the condition of the bank was so brittle, or in such delicate equilibrium, that "our ability to absorb hits, as you put it, is a function of some arithmetic". The following exchange with Commission counsel paints in an important part of the picture:

> Q. Now, a cornerstone of this strategy I suggest was that income was recognized not on the basis of current values of the assets underlying the loans as security, but on the future values of the assets, the added value, that value that would be added over a period of probably three years?
>
> A. (Neapole) You mean in terms of income recognition?

> Q. Yes.
>
> A. (Neapole) I suppose maybe you are also talking about provisioning as well, but in any event, we have talked at some length in specific instances earlier in the past few days about the validity of the income recognition case by case, and to the extent that all comes back into this kind of a question, I guess the answer is yes.

Neapole said of the process of adding value, "... I guess the proof in the pudding is where you end up at the end of the day, assuming that you get to the end of the day". He added that in this process "certainly earnings is part of keeping confidence". The question was then put to him:

> Q. ... You said, on the way through the strategy the right number for provisioning income is the number that works and the vindication of those numbers would be at the end of the turn around process; is that a fair statement?
>
> A. Assuming you could define precisely when the end of the turn around had happened, yes.

Turning to another aspect of the crisis management which Neapole was in the process of installing in 1983, he stated that it was necessary to assess the level of tolerance which would be exhibited towards these management tactics:

> ... Somehow I had to try to measure what level of tolerance there was out there for a turnaround. Tolerance in the minds of auditors, regulators, depositors, other banks, the system if you like.

In his judgment there was tolerance for his strategies and in his testimony he stated that the regulators and the auditors of course would have to know what those strategies were.

In summary, a major part of the strategy of the bank in the Neapole era was to apply accounting procedures to management's policies and actions that would maintain the appearance of health through the bank's financial statements in order to survive until the salvage workouts could succeed. It was in this era that the "loan warehouse" concept of workout or rehabilitation of unsatisfactory loans was shifted into high gear. Epicon was such a case. It was established for the purpose of receiving from the bank about $100M in bad loans or recovered security taken by the bank on loans which had turned bad. Epicon's mandate was to turn these unsatisfactory real estate loans into assets of positive value by development, realization or otherwise. Epicon will be considered in more detail shortly. It can be seen from the most casual examination of the lengthy testimony on these issues that, like CCB, Northland Bank's management was treading water so as to stay alive until the recession passed away and prosperity returned to Western Canada, the theatre of the bank's operations. How the two banks managed to stay afloat has been a matter of much discussion in Chapter 4, and only the differences between the two banks will here be touched upon. While there are, of course, terminological differences, there would not appear to be much difference in substance between the present evaluation of future prospects as applied in CCB and Northland's technique of adding value to the present by reason of future expectations from workouts and related developments.

Other components of the Northland strategy were the development of a retail funding base and addition to the bank's capital. Northland had not proceeded very far into the 1983 fiscal period before liquidity problems were encountered by reason of the ricochet effect of the Eaton-Rosenberg episode in CCB. Support for Northland came in the form of a $250M credit facility with the five large Schedule A banks, which remained in place with renewals from time to time until June 1985. About the same time, Northland management realized that the design plan of reliance upon wholesale funding was defective. Accordingly, a program was commenced in late 1982 to raise retail deposit funds, and gradually through 1983 and 1984, these deposits increased to more than $500M by July 1985. This was a beneficial development except that the start-up costs for the retail deposit-gathering system are not known. While it is known that Northland Bank's cost of money was higher than other banks, it is unclear how much this adversely affected the interest spread in the bank.

Unfortunately, a planned increase of capital through the sale of $35M in preference shares and debentures scheduled for March 1985 was cancelled as it was impossible to go to the public for funds after the announcement of the CCB rescue program. In the meantime, the bank had raised by private placements and debenture issues in 1983 and 1984 some $40M, and in May 1985, a private placement of $16M in debentures was closed. It is a measure of the difficulties in which the bank was wallowing in these years that, given a reasonable leverage of 20 times, the $56M new capital would have supported a loan portfolio of some $1.1B. At an interest spread of one per cent, the new loans would produce net earnings before taxes of $11M annually. No such returns were gathered because the bank could not produce an interest spread at that rate, and could not put out slightly over $1B (apparently) without creating a burden of bad loans, or at least loans of little or no productivity.

Indeed, the strategy of dilution of NPLs by adding new loans was adopted during the depths of the recession when good loans were difficult to find. The other banks in the face of this recession had curtailed lending. During this period, however, the loans grew at an amazing rate. From $510M in fiscal 1982, the portfolio expanded to $622M in 1983, $945M in 1984, and peaked at 31 August 1985 at $1.183B. This increase of loan portfolio by two and one quarter times occurred at the height of a recession which both banks strenuously submitted was the cause of their respective ultimate collapses. To put out such significant sums in the face of this adverse economic climate raises considerable doubt about the wisdom of the aggressive and innovative approach of management in this troubled bank. The Inspector General observed that such growth increased the risk exposure of the bank and appeared to be partly motivated by a desire to take on new business in order to generate fees to fatten the income statement. An unknown proportion of these new loan moneys appear to have poured out of the bank into workout situations. This increased the exposure of the bank but supported the bank's insistence upon maintenance of classification of the loans in question, and the postponement, if not the indefinite avoidance, of the taking of specific loss provisions. These criticisms must be moderated to some extent by the fact that Northland created some of this new lending through the Toronto office which opened in late 1983. Presumably the success record in this lending was much better than the bank's experience in the older Alberta loans, as the evidence was that the recession moderated much more quickly in Ontario than in Alberta.

Much evidence was devoted by management of both banks to demonstrating that sound banking policies and practices were put in place and that manuals detailing credit-granting procedures were adopted, revamped and up-dated. However, as Commission counsel said, it is one thing to have a document as perfect as the Russian Constitution, but quite another thing to put it into daily practice. Neapole testified that he never did read these manuals because the management of a small bank was aware of what was happening in the bank, and manuals in this scale of operation were unnecessary. The same philosophy extended, as will be seen shortly, to the treatment by senior management of the internal inspector's report.

There is a serious overriding question as to whether latitude should have been accorded to the management of Northland to embark upon these survival strategies and thereby put at unnecessary or enhanced risk those who had occasion thereafter to deal with the bank. The issue of tolerance and acquiescence in these practices by regulators and auditors is the same in the case of both banks. The perhaps unanswerable question is how much the depositors, other creditors and investors lost because Northland did not go into liquidation by reason of undiscovered insolvency at some date earlier than 1 September 1985 (or more accurately, 20 January 1986).

Mention should be made of a report by Hay and Associates Limited which was the result of a study commissioned by management in late 1984 on the corporate and management structure of the bank. There is no question that senior management, when commissioning this report, instructed the consultant "to be tough in his assessment". The report was delivered in December 1984. In summary, it found that the bank had no goal other than survival, that its "culture" was out of balance, that a senior officer should be fired, and that the management information and financial management systems were in a state of crisis. There is no doubt that many of the recommendations in this report were implemented by the Neapole management. The significant value of this report, however, is that it clearly demonstrated in its very direct message that real and serious problems abounded in the bank even as late as December 1984. The content and tenor of the report is, furthermore, a ringing condemnation of the management which had gone before. It is equally difficult to understand how a bank could be in the condition described by the Hay Report without having prompted similar comments in the annual inspections and interim reports by the Inspector General.

b. Management of the Loan Portfolio

If the Northland Bank were measured by conventional banking standards, many of its loans would not have met normal tests of prudential judgment, and as such, would not have supported their historical carrying value in the balance sheet. To survive, management required time to improve the loan portfolio by patching up the damage, and in so doing, the conventional tests of loan valuation, the ability of the borrower to pay and the value of the underlying security, were not truly reflected in the bank's assessments of its loans. By conventional standards the bank could have closed its doors sometime in 1983. It did not do so but rather adopted a strategy of asset management which included the management of the income statement. The principal instrument in doing so was the adoption of workout schemes of one form and another. This strategy, of course, required an adaptation of the concept of the "banker's final judgment" as to the ultimate collectability of the loan. On the Neapole formula, this meant selecting a value which would work. This value, however it may have been described, was computed with reference to future values augmented by a real or fictional element reflecting the added value which was thought to adhere automatically to the asset once the workout program was instituted. This enabled the bank to avoid provisions and to recognize in its income accrued interest. Whether or not the borrower was able to support the loan from its own resources seemed to be an irrelevancy, and the absence of such capability did not in any way embarrass the management.

The whole business was based upon a series of fundamental assumptions by management. First, in the words of Neapole, the bank had to assume a generous measurement of "system tolerance". This meant acceptance of these concepts first by the external auditors and then, by what appears to have been a much easier process, by the regulator, the OIGB. Management drew considerable comfort from the fact that both the regulator and the auditor knew of the workout strategy and the foregoing assumption. Second, but much less importantly, management had to assume some improvement in the economy. So long as system tolerance permitted, management possessed an open-ended licence to continue operating at least until the paper accumulation choked the cash box and there was not enough hard currency to meet current obligations.

The system falls down completely not so much on a loan-by-loan analysis but on considering the overall impression of a neutral observer who "stands back", in the words of Broadhurst. This observer would recognize that the bank could not afford to take major reserves for bad loans. The application and reapplication of workouts are then seen simply as a device to trigger the necessary favourable accounting treatment needed to create the facade of acceptable financial statements. The requisite end figure dictated the magnitude of the formula and therefore the process was never wrong. Probably the greatest ally this managerial philosophy or doctrine had was the abhorrence of any person, be he regulator or auditor, of being the instrument which brought about the closing of the doors of a bank. Abhorrence is another expression for system tolerance, and management of Northland Bank played it for all it was worth.

It is unnecessary to dig into the inner workings of the schemes adopted. It is sufficient to recognize, for example, that according to the doctrines of Northland Bank as applied by their principal advocate Neapole (and sometimes generously approved by the external auditors), an NPL does not necessarily require a provision, the level of loan loss provisions in the financial statement does not necessarily reflect the actual number of NPLs in the loan portfolio, and a loan need not be classified as nonperforming if some workout plan can be devised to produce a future security value that justifies advances by the bank of funds to service the loan in the meantime. These doctrines allow the bank to drift away from a cash basis which the financial statements thereafter never reveal.

According to the rules created by Northland Bank (but not applied), only the lowest loan grade, No. 5, mandated a reserve. The statistical result in the managed accounts reveals an interesting picture. In fiscal year 1982, nonperforming loans amounted to 11.7 per cent of total loans, the provisions for loan losses reported in the financial statements for the year were $2.2M, and specific provisions booked were $3.85M. In fiscal year 1983, the nonperforming loans amounted to 17.2 per cent of the total loans, provisions for loan losses at year end were $3.29M, and specific provisions booked were $6.99M. In fiscal year 1984, the level of NPLs fell to 8.4 per cent of the total loan portfolio, provisions for loan losses were $4.6M, and specific provisions booked fell to $6.7M. Expressed in percentage terms, provisions for loan losses as compared with total loans went from 0.43 per cent in 1982 up to 0.53 per cent in 1983 and down to 0.49 per cent in 1984. This picture reflected a stable condition of provisions expressed as a percentage of the total portfolio. There was also a slight improvement in NPLs through these three fiscal periods expressed both absolutely and relatively. The magic wand was the workout. In the hands of management, loans which might otherwise move into the NPL category did not so move, with the beneficial consequences that capitalized and accrued interest continued to be recognized and provisions were avoided. The reader of the financial statements and the annual report for fiscal year 1984 might well go away with the impression that the bank had survived the crisis, was out of danger, and was a reasonable institution in which to invest or deposit funds. The question is, however, whether the bank had so managed its asset and income statements by using arbitrary numbers for provisioning, accrual of interest, and loan classification as to produce a survival formula. Whether this is so depends upon the reality of the condition of the bank as determined by independent, qualified reviewers. We shall return to this shortly.

The key to all this, of course, is the variable valuation concept variously referred to as future value, investment value, or baseline value. In Northland Bank, the term "added value" is preferred. Neapole agreed that the future value of assets, that is the current market value plus the "added value", could be accumulated over a period of three years. This figure sustained the management override in order to continue the recognition of accrued interest income and enabled management to ordain that there was no doubt about the ultimate collectability of principal and interest because the magic floating quantity of future value always seemed to rise to the occasion and exceed the principal sum of the loan plus accrued and capitalized interest. Mr. R. Guenette, one of the principal officers of the bank, was asked about this process and gave the following answer:

> Q. Is it the fact that in valuing this piece of property for security purposes, the bank's valuation figure was its estimate or the purchaser's estimate that the property would bring two years hence?
>
> A. Yes, sir, that is correct.

Carried to its logical conclusion, this concept would destroy the underlying assumption in all financial statements that the financial statements can, by the application of a series of constant rules, depict with reasonable accuracy the financial position of the business entity and the results of its operations at the fiscal year end. In the language of many witnesses, a snapshot of the bank at that time, in the form of financial statements, should depict the position of the bank according to the GAAP rules as modified by the *Bank Act*. The Neapole management team, on the other hand, took the view that, by reason of the conditions in which the bank found itself, it was misleading and inappropriate to take a snapshot of the bank, and particularly its loan portfolio, at a specified point in time. Subsequently, the curator concluded that the specific provisions on loans taken by the bank were grossly inadequate. Senior management's response to the curator's assessment of the survival tactics illustrates their view:

> ... it is inappropriate to take a snapshot of our portfolio at one given point in time. We feel that it is not possible to properly judge the quality of the portfolio and the appropriate carrying value on the books of the bank, without measuring the progress made to date by Northland's management and staff against the business strategies employed. We feel that these factors are understood by those that really know and understand the bank, such as our auditors, our clients, third parties who have completed significant transactions with us such as Hees International, and others who are active within the difficult markets in which we have operated.

Management seemed to prefer the moving target concept whereby the loan in question could be moved back and forth in order to avoid the oncoming need to take a loan loss provision, or to cease interest accrual and reverse prior accrued interest. The workout was seen as the final *coup de grâce* of any requirement for valuation of the loan or the underlying security at the time specified in the financial statement. Neapole explained:

> As I said earlier, the basic commodity in the business in terms of asset management is judgment and judgment, because of reporting requirements, has to be quantified annually, audited and so on, a set of numbers must be produced, and those numbers, in essence, reflect the aggregate of all of those judgments.
>
> . . .
>
> What it does do, essentially, is say, use your best judgment.

This is the ultimate in flexibility, injecting into accounting an infinite elasticity in the valuation process, and in all the quantities which flow therefrom including loss provisions. From there on the valuation process is a battle of words and self-defining terms. For example, according to Mr. R.J. Mackay of Thorne Riddell, one of the bank's auditors, there are various expressions all to the same end such as "the expectation of future values". But sometimes the policy or proviso was described differently:

> ... investment value did not mean the current forced sale price of a property but rather the value which could be derived from the reasonably expected price of the property within a reasonable time frame.

This description does not square with the practice in the banking industry as evidenced by memoranda and testimony. The hard reality cutting through the evidentiary debate about the distinction between going concern value and liquidation value is that the value of the bank's assets at the date stated in the financial statements should not, according to generally accepted accounting principles, depend upon "future values" predicated upon a revival in the economy or some uncertain expectation in the undefined future. All of this was described by a very long line-up of witnesses with extensive experience as bank credit officers. Some were retired; some were active bankers. None were able to report that any such concept had been applied in the bank where they work or had worked over the years. Perhaps even more fundamental is the recognition that no operational decision by management can necessarily mandate the accounting treatment which must be applied by the external auditors when determining whether the financial statement advanced by management fairly reflects the financial position of the bank. In the words of Garth MacGirr, the liquidator of CCB, if such were not the case, a bank could forever avoid cessation of recognition of accrued interest or the taking of a loss provision against the carried value of a loan.

c. Capitalization of Interest

The subject of capitalization of interest was fully canvassed in connection with CCB, and, apart from the fact that no compilation of capitalized interest was found in the records of Northland, the situation in the two banks would appear to be approximately the same. Northland, in its loan warehousing and workout arrangements, made a considerable practice of advancing money to new borrowers to acquire assets from the bank or from a receiver of a borrower, and these new moneys included "operating loans" and other advances to carry interest either then in arrears or accumulating in the period after the loan arrangements were made. In these cases, the bank's exposure for both principal and interest advanced was increased. The arrangements reached such proportions that Willy, a Chief Inspector of the bank, and Mr. Stan Cook, a retired banker who joined the OIGB, both commented that it would be difficult for a borrower to fall into default. As in the case of CCB, ultimate collectability was an exercise of bank management's judgment that interest may be capitalized, and this judgment was in turn based ultimately upon the determination of the future values of the property in question. Different terminology produced the same result in both banks.

Mr. R.W. Korthals, President of the Toronto-Dominion Bank, in discussing loan provisioning and its relationship to recognition of income, made the interesting observation that in his bank the decisions to terminate accruals of interest and reverse theretofore recognized income were taken automatically when the collectability of the loan came into doubt, rather than taking a loan provision. The latter, because of the five-year averaging formula, had a reduced impact on current earnings and therefore the establishment of a nonaccrual status had a more salutary and realistic effect on the income of the bank in the year in question. (This policy was recently supplemented by an additional minimum loss provision to encourage the adjustment of original loan values to current values.) Had this same thinking been applied in Northland, and indeed in CCB, capitalization and accrual practices would not have been allowed to intervene and distort the presentation of the bank's financial position in its statements.

While it is difficult to be precise, the activities in Epicon and like operations and the extensive workout arrangements, give some insight into the extent of the practices of recognizing accrued interest and of capitalizing interest in Northland. There is also evidence in the OIGB files that, during the first 2 quarters of 1985, the bank had capitalized $12M on loans totalling $289M, of which $8M was capitalized on $103M of restructured loans. It is reasonable to conclude that the extent of capitalization of interest (whether in arrears or upon the sale of a repossessed asset to a new buyer from Epicon or the bank in what was essentially a workout) and income recognition practices generally were at least at the same level as in CCB, and indeed, may well have been proportionally higher.

d. Nonperforming Loans

The classification of nonperforming loans presents an interesting insight into the workings of management in Northland Bank. A memorandum on the subject of nonperforming loans described the rule in the Willson era:

> ... the Inspector General has asked us to designate any loan, for which interest is 90 days in arrears, as nonproductive. At that point interest ceases to be accrued, except in rare instances where interest recovery is adjudged by the vice-president, credit, and the senior vice-president, to be imminent ....

That policy was changed near the beginning of the Neapole era, undoubtedly in response to the pressure of increasing nonperforming loans. The change in the definition of NPL is reflected in a note to the 1984 financial statements (which is almost identical to the note to the 1983 statements):

> Loans are classified as nonproductive when, in the opinion of management, there is significant doubt as to collectability of principal and/or interest, in whole or in part. At the date when a loan is classified as nonproductive, the accrual of interest ceases. After taking into consideration loan security and other factors, previous interest accruals may be reversed and a specific provision for loan loss may be made.

The auditors pointed out that in the Neapole era, as it was not necessary to take a provision on an NPL, the level of provisions in the financial statements may not match the level of the NPLs. Even faced with this, Neapole did not agree that the bank, in changing the definition of an NPL, moved to a less conservative accounting basis. The auditors, Thorne Riddell, however, advised the OIGB that, "The bank had followed a very conservative policy in ceasing the capitalization of income once the loan stopped paying for 90 days" and that this was no longer the case. The OIGB agreed.

The most significant element in the process was the recognition by the auditors that the final decision on whether a loan should be placed in the NPL category resided in senior management. This is illustrated by the chain of events commencing in August 1983 when Willy wrote Willson, drawing to his attention a significant error in the 1982 annual report:

> ... Accrued but uncollected interest is reversed whenever loans are considered nonproductive. The Bank classifies a loan as nonproductive when, in the opinion of management, there is significant doubt as to collectability of principal and/or interest, in whole or in part.

Willy pointed out that the bank's records indicated that an amount of uncollected and unreversed interest had accrued on NPL loans and that the first sentence in the above quotation was not being applied. The external auditors, however, reminded him that the second sentence in the above quotation left with senior management the exclusive power to determine ultimate collectability and hence the classification of a loan. The auditor, Mr. W.K. Detlefsen, of Thorne Riddell, concluded that the records which Willy had examined did not reflect the exercise of judgment by senior management on collectability. The bank was therefore left in the strange position that its accounting records, and the classifications by lower management reflected in those records, differed from the final classification, although the accounts later were not corrected. This illustrates the frequent use of the management override, and accordingly it is reasonable to assume that the condition of the loan portfolio, at least as regards those loans which were truly nonperforming, was not adequately reflected in the financial statements commencing in 1982. This was most certainly the case by 1983. In 1983, for example, Willy estimated that, in the four loan platforms or branches inspected by him in that year, a total of almost $2M of unreversed interest was reflected on nonperforming loans. In the light of the bank's before tax earnings of $2M in that year, that is a very material sum. The level of NPLs, as already noted, declined from the 1983 fiscal year to the 1984 fiscal year, and indeed, by the third quarter of 1985, the bank's financial statements revealed only $43.4M in NPLs.

The liquidator, on the other hand, assisted by Royal Bank personnel, estimated that actual NPLs in the bank were about $325M, much higher than reflected in 1983 through 1985. If this was so, and there is no reason to question the accuracy of the liquidator's analysis (which is supported by McLeod's and other independent assessors' figures) of the status of loans in the portfolio of the bank, then the only conclusion is that the exercise of managerial override and other devices enabled the bank to avoid classification of loans as NPL on a large scale for the reasons set out above as part of survival accounting tactics. The true level of NPLs explains the woeful condition of the bank which was dragging it inexorably into liquidation. It also leads to the conclusion that by 1984 the financial statements of the bank had seriously departed from reality.

e. Loan Loss Provisioning

Loan loss provisioning, like classification of bad loans and interest accrual, was, in the hands of Northland management, an elasticized accounting procedure whereby the level of income revealed in the bank's statements could, in its latter years of existence, be regulated according to the bank's needs. One variable element was the proposition that no provision need be taken so long as security values, based of course upon future anticipated economic levels, were sufficient to make principal and interest ultimately collectable in the view of management. In the case of workouts, the auditors' testimony was that no provision was considered necessary if management's expectation that the workout would be a success was reasonable. Epicon, as described by Neapole in a discussion paper presented to the Board of Directors, would have such a cushioning effect on the bank's statements and would be "a significant factor in determining final provisions" for the year, and indeed, would permit "the bank to show a profit for the year". Management's philosophical view of the entire provisioning process is discernible from their adoption, on at least two occasions, of the proposition that the bank might properly set a level of provisions for a given period and hold loan loss reservations to that level. Consequently, the bank would be able to transfer any "freed-up" loss provisions arising from unexpected loss recoveries for application to other loans. This is revealed in a memorandum by a Vice-President in December 1983. It also is apparent from a conversation between the Vice-President of Finance, Mr. H.G. Green and Mr. J. Courtright of the OIGB, wherein Green stated: "The freed-up specifics would be applied to other loans in the portfolio". This subject is later discussed in more detail.

f. One Hundred Per Cent Bank Financing

Mention has already been made of the practice of 100 per cent financing by the bank through the purchase by shell corporations of security held or recovered by the bank. Sometimes, of course, 100 per cent financing is entirely proper and innocent. It may occur, for example, after a loan has been made, if the value of the security taken or the value of the subject of the entire transaction has shrunk in the market to the level of the loan or lower. There are many instances, however, in Northland accounts where the original borrower or successor borrowers in the same transaction or project, with the aid of subsequent advances by the bank, put none of their own money into the business. Without exception, those who have had occasion to review or examine the loan portfolio of Northland Bank have reported the alarming level of loans where the borrower, original or ultimate, had "no equity" in the project. One of the Inspector General's inspectors critically commented on the practice: the banker's role was to assist with a project, not buy it. Management, of course, contended that the realities of the recession in Alberta and British Columbia were such that no person in the business world would come forward and join a workout where he is knowingly succeeding to the position of a failed borrower if the transaction involves any investment of his own money. His investment is his time, his skill, and his energy. There is truth in this side of the story, however, the financial statements of the bank must fairly present its position. A provision must be taken where the ordinary rules of bank accounting so require whether or not the loan is an example of 100 per cent financing. That feature is neither irrelevant nor controlling on the issue. The judgment must be made having regard to the presence of 100 per cent financing as a factor.

g. *Fee Income*

Fee income is another item in the banking business which, if improperly or unconventionally treated in the records of the bank and in its financial statements, can distort the latter. There are two basic problems. First, some fee income is a charge in lieu of interest, or is a reward charged by the banker for granting the loan. Such charges are inaptly described as fee income and ought to be labelled as interest charges. Other fee income originates from the provision of services by the banker to the borrower not traditionally related to the granting of the loan itself. For example, the banker might, in the sense of merchant banking, bring partners or joint venturers together for the purpose of the transaction in question, retire or consolidate pre-existing indebtedness, or provide some other organizational service not traditionally associated with the bare making of a loan. Fees in the latter sense can be taken into the income of the bank in the year in which the services were rendered. Payments received in lieu of interest must, however, according to generally accepted accounting principles, be amortized over the life of the indebtedness. This was acknowledged by the bank in its 1984 financial statements.

The problem is whether these principles were consistently applied by the bank and its auditors. There is no question on the evidence that banks in Canada have moved into that aspect of merchant banking which generates fees which are truly independent of their loan-related activities. Neapole has stated that Northland Bank so emphasized this part of its business that it became a hybrid, a mixture of a traditional bank and a merchant bank. Two of the retired bank credit officers engaged by the Inspector General to examine the loan portfolio of the bank concluded that the fee income of Northland Bank was inordinately high and that there appeared to be many cases where the opportunity to exact a fee from the transaction was the overriding consideration in making the loan. One of these examiners, Mr. Karl Adamsons, stated:

> In these cases, it appears that an analysis of the underlying value of the project and security is given a back seat to fee income considerations.

Other income (in this bank, mostly fee income from loan business and merchant banking) in the 1983 fiscal year was $2.4M, as compared to $8.1M in 1984. By the end of the third quarter of 1985, "other income" was $8M. This substantial fee income made the difference between a profit and significant losses in the 1984 fiscal year and in the 10-month period ending 31 August 1985. Discussions between the external auditors and the bank in connection with the 1984 audit resulted in the reduction of the amount of fees charged directly to income without amortization by some $400,000. This matter is dealt with in connection with the auditors' activities later.

An example of the bank's pursuit of fee income is illustrated by a loan where the acting Vice-President, Credit (and Chief Inspector of the bank), McLeod, opposed the granting of a loan to the proprietor of a drug store in Alberta for the purpose of purchasing land for a hotel site in Hawaii. The loan was eventually made in the amount of $6M and included a $650,000 fee to the bank. The loan was not complicated and there seems to be no reasonable basis for a fee of that magnitude, unless it was in lieu of interest. McLeod viewed the loan as unattractive from a credit viewpoint while Fortier took the opposite view. Neapole approved the loan by a tie-breaking vote wearing, as he put it, his "businessman's hat" as opposed to his "banker's hat". McLeod to the end maintained the view that the only merit in the loan was the fee, which, of course, was paid to the bank from its own money.

Fee income similarly seems to have been the main attraction in a series of loans made under the SBEC program established by an Alberta statute. These loans threw off a considerable flow of fees, although the exact amount seems to be in doubt on the evidence. Adamsons reported on the SBEC loans as follows: "The danger is obvious. After two years, bank security will consist of minority equity investments in small companies". The most reasonable conclusion available on the evidence is that the purpose of the bank in entering into this extensive program was to generate fees in order to pump up its income statement in these perilous years.

Other substantial loans were made by the bank under circumstances that lead the Commission to conclude that such transactions were "fee driven". The Inspector General, shortly before the closing of the bank, observed that Northland Bank was "playing games with fee income". The auditors took a different view, and apart from the one incident already noted, saw no reason to conclude that the fee income, as treated by management, had distorted the financial picture of the bank contained in its financial statements.

h. Epicon Properties Inc.

To best dispose of sterile assets, namely bad and unsatisfactory real estate loans and repossessed security in the form of real estate, management decided to interest an expert or experts in real estate in a joint venture. This they did by the formation of a company, Epicon, 55 per cent of the common shares of which were held by the bank and 45 per cent of which were held by another company, Ellsmere Developments Ltd., of which 80 per cent was owned by a public company, Agra Industries Limited, and 20 per cent by a company owned by two real estate entrepreneurs, Messrs. Wettstein and Walker. There was $100 of common equity issued. The bank paid all the administrative costs of operating Epicon, including a fee to Walsten Management Ltd., the corporate vehicle of the two real estate entrepreneurs. These gentlemen were also by contract accorded all the perquisites and status of senior officers of the bank. Thus Epicon was financed entirely by the bank. The other venturers advanced nothing except the time of the real estate entrepreneurs for which they were compensated by the bank.

The plan was simple. The bank would transfer real estate assets to Epicon for a transfer price agreed to be the lesser of fair value of the properties as determined by the appraisal of Messrs. Walker and Wettstein and the book value of the bank (principal plus capitalized or accrued interest). The auditors testified that, in most cases, the transfer price was the latter. A considerable amount of evidence dealt with the "fair value" established for these assets by Wettstein and Walker. It was agreed by all witnesses concerned with Epicon that the properties themselves did not increase in value from 1982 to 1983, the year of the transfer. Rather, the underlying value of the security was valued differently by Messrs. Wettstein and Walker, and this was relied upon by the bank and the bank's auditors in setting aside a reversal of accrued interest which had occurred in the bank's accounts in 1982. In 1982, some accrued interest was taken out of interest income or reversed because the loan was in default and the value of the security would not then support the recognition of the accrued interest. In 1983, this excluded interest was put back into the income of the bank because of the value then assigned to the security by Epicon management. The difference in value brought about by the tranferee's "appraisals" was effectively taken into the bank's income through what an OIGB inspector described as "the retroactive booking of the accrued interest".

The auditors justified their approval of these accounting gymnastics on various grounds. Detlefsen thought that the initial reversal had been overly conservative and that the ultimate correction proceeded on the basis of the adoption by the bank of reasonably conservative practices allowing the bank to recognize that the principal and accrued interest did not exceed the "fair or realistic value of the property". McKay did not recall any discussion concerning the degrees of conservatism exhibited by the bank from time to time, but rather adopted a new concept, namely "investment value" which, if not exceeded by the combined principal and capitalized interest, would justify the retroactive recognition of uncollected interest. Management was more forthright, and simply stated that at the time of the transfer they had exercised a "fresh judgment" on the value of the transferred assets, and as this new value exceeded the value of the assets on the books of the bank, the recognition of accrued interest could be renewed.

All of this accounting was by no means incidental to the formation of Epicon, and it can only be reasonably concluded that one of the purposes of Epicon was to permit on a large scale these accounting practices which produced new income in the bank's financial statement for 1983. All this was done in spite of the fact that no one at any time throughout these hearings argued that there had been any significant improvement in real estate values in the Province of Alberta in the continuing recession of 1982 and 1983. The end purpose and driving thrust of Epicon was to postpone or defer the taking of major write-downs of loans and recovered assets. In short, it was a protective shroud over both the balance sheet and the income statement of the bank in the fiscal years 1983 and onwards.

Management announced from time to time that Epicon was successfully disposing of assets. In almost all cases, however, dispositions were to a new borrower, created for the purpose of purchasing the property, who would borrow from the bank not only an amount equal to the book value of the security for the purchase price but also such additional moneys by way of an "operating loan" which would allow for the "payment" of interest to the bank until the workout plan came to fruition. The result of this additional step was the creation of a new current loan which would remain current through the use of the bank's own funds for the next accounting period. Current loans would thus be reflected in the financial statements even though the position of the bank vis-à-vis the security was precisely the same as before the property was transferred to Epicon. The bank's accounting position was thereby greatly improved in that it could again recognize income. The fact that Epicon's "disposals" were at the expense of the bank was not appreciated by Willson and probably also not by the Board.

It must be wondered why it was necessary to interpose Epicon at all in this wholly internal and artificial transaction. In at least one instance which the Inquiry examined in detail, the rollover transaction was repeated twice after Epicon, each time by the use of a shell company which held only one asset, namely the security which the bank had foreclosed in the pre-Epicon stage of the loan. Epicon was not necessary in the second and third jump of the property. Values did not increase in the market sense but only in the book sense, and only then by capitalizing interest. Epicon was truly analogous to a used car dealer set up to take over the trade-ins by a franchise dealer. Occasionally, the used car dealer might, at the expense of the franchise holder, repaint a car, but otherwise its function was simply to house the vehicles pending disposal, hopefully to the public. That last stage rarely occurred so far as the records before this Commission show.

The justification for all this procedure according to the bank was that the combination of real estate expertise and the real estate security in the hands of the bank was necessary to maximize recovery from these troubled loans. Qualified partners, it was said, could only be interested in such a project for a participation in end products. This was doubtless a "second intent" and without more, this process would be acceptable. The interposition of Epicon, and all that flowed therefrom, served other purposes. The financial statements and the bank's financial condition were on diverging courses.

Mr. J. Morrison, the liquidator, having examined these transactions, came to the conclusion that the transfer to Epicon and subsequent rollovers to shell companies did not improve the position of the bank. The effect of Epicon was simply to burden the bank with the overhead of operating the company and to freeze the bank's interest to recovery of its book value through redemption of the preference shares received from Epicon, plus 55 per cent of any extra recovery net of expenses which Epicon might effect, and less the expenses of Epicon paid by the bank.

When the bank closed, the properties remaining in Epicon had a book value of about $16M. The liquidator considered there would be a shortfall on realization of this property of $10M. The liquidator also estimated that on the properties rolled out of Epicon under 100 per cent bank financing, the loss would be about $31M. Financial statements of Epicon produced from bank records showed that it never made a profit. There is nothing in all this evidence to indicate that the venture of Epicon added any value to anything except possibly to those on the payroll of Epicon. In at least two instances, the properties transferred from the bank to Epicon eventually rolled through two newly set-up borrowers and into a proposed disposition to a company known as Rondix which was to be established by the bank as the ultimate burial ground of all the bank's worst loans. Epicon appears to have been only one section of the pipeline through which these bad loans were ultimately scheduled to be drained into Rondix. Some Epicon properties also drained into Dexleigh, another large transaction. Of "added value" in these transactions there is little or no evidence. The bank's exposure through these loans continued to rise with the creation of debt servicing loans but the underlying security values did not seem to improve. If Epicon was a success, it was so only because it performed the accounting magic of restoring loans to accrual status and permitted avoiding the need to take provisions; both of which were, by themselves, valuable results for the bank.

i. Other Workouts

There are many other examples of workouts through the use of intervening companies whose assets consisted only of the property under workout. The fate of many of them was, from the bank's viewpoint, precisely the same as Epicon. Clearly the bank preferred to disobey the old banking adage that "your first loss is your lowest loss" so as to be able to end up with a new performing loan, rather than an NPL, and to avoid write-downs and write-offs or, at the very least, postpone them to the last possible moment.

This process had a deadly by-product. Through sequential rollovers and debt servicing loans, recognition of accrued income and other like practices, the bank exposure grew and grew. Indeed, on occasion, the bank was encouraged, either by prospects of commercial success or in desperation, to move the loan along one more time, to grant extensive loan increases of which the most spectacular example is the loan in the Cayman Islands. This loan grew from a $2M (U.S.) exposure in 1980 to $56M (U.S.) today. Each step is entirely explainable, at least in the eyes of some witnesses, yet no turn of the road produced any return of capital, or even interest, to the bank. Even today there are witnesses who will speak glowingly of the commercial prospects of the secured properties. The hard fact is that the bank, at the end of the day, had about 50 per cent of its total capital invested in a hotel and golf course property in the Cayman Islands in the Gulf of Mexico. Diversification sometimes comes at a high cost.

These are but a few of the examples of the end-of-the-line survival banking carried on by Northland Bank in its last years. Sometimes these moves took on the appearance of pure desperation, for example, the granting of two huge 20-year loans with an interest cap of 11 per cent, but in no case more than the bank prime rate less 1/2 of 1 per cent, in return for involvement in real estate deals which held out the advantage, however remote, of a market for some of the repossessed security in the hands of the bank.

Management's resolve to pursue the workout strategy manifested itself as well in its dealings with the OIGB. If the required "system tolerance" did not exist, management was prepared to create it or at least help it along. When faced with the Inspector General's concerns about the bank's growth strategy and his suggestion that the bank enter an undertaking regarding the growth rate, Neapole responded:

> While I am quite prepared to meet with you and members of your staff at any time to review and discuss the Bank's current status and near term plans, I would resist strongly, entering into any undertakings to restrict growth beyond the type of assurances we provided to the big banks and to the Bank of Canada

> and Mr. Grant in our presentation. Certainly with us preparing a prospectus and about to seek a credit rating, I believe any customized regulatory constraints on the Bank would be counter-productive and risk undoing a considerable amount of the repair work of the past 18 months.

The Inspector General responded by stating that the OIGB would shortly be in touch with the bank to arrange a meeting to discuss growth rates. That never occurred.

It is difficult in hindsight to condemn management when their energies were devoted entirely to a struggle to overcome the fully appreciated realities of the bank's adverse position. There is no suggestion in the record that there was any motive at all improper, or any personal advantage or gain to any manager for undertaking these measures, some of which can charitably be described as bizarre. They were, it is suggested, the product of an intense effort on the part of senior management with broad banking experience who were endeavouring to stay within the rules, stretched though they may be, while still carrying the bank across a very long and dangerously thin strip of ice. However, there is a line which management is never entitled to cross, the point where to prolong the life of the bank further is to expose to danger the assets and well-being of those who unwittingly deal with it. Courageous bank management is one thing but complete and accurate disclosure according to the rules of the road in banking must be at all times present. Here, that line was crossed, probably as early as 1982, but certainly by 1984.

4. Impact of the CCB Collapse

There are many contradictions and conundrums in the scene at Northland Bank at the time of the fateful announcement that the CCB had encountered serious troubles and was to be the subject of a rescue program. The immediate effect on Northland was nearly fatal. Here was an even smaller bank, more concentrated in Western Canada than CCB, more exposed to Alberta real estate and energy loans, with a history of less stable and less experienced bank management than the CCB. The financial markets must surely have wondered whether the Northland Bank portfolio would, on close analysis, reveal the same conditions as were becoming apparent in CCB. It was natural to expect investors to react as they did. Depositors fled to higher ground. A proposed securities issue by Northland Bank was grounded indefinitely.

Northland Bank management assert one other serious fall-out effect from the CCB development. From 25 March onward, in their view, the regulatory environment changed and the regulators looked upon Northland Bank quite differently. In the result, the bank's workout strategies were criticized, the bank's growth in loan assets was viewed with increasing alarm, and the bank was forced to jettison some of its programs just before the anticipated profits were to be reaped, or so it was argued. Perhaps left to itself and without the earthquake at CCB, Northland Bank would have struggled along and gained the time necessary to straighten out its loan asset problems. As Commission counsel has said, however, the effect, even without a CCB collapse, of the recent oil price reductions on Northland would require a strong constitution to contemplate.

It is true that, viewed superficially, the picture was getting a little rosier at Northland Bank up until 25 March. The annual report in October 1984 highlighted some of the apparent gains in recent times. These developments included the substantial growth in loan assets, the reduction of NPL levels, the increase in net income, the success of the retail deposit program, the generation of fees by the merchant banking group, the apparent workout successes including Epicon, the stabilization of loan losses, the slight improvement in the general economy, the elimination of interbank borrowings, and the successful preparation for a preference share and debenture issue scheduled for 27 March 1985. Some of this can be corroborated. For example, Wood Gundy, the bank's underwriter, had canvassed the regulators, the auditors, the Bank of Canada, and the market, and were satisfied, on the basis of positive responses to the bank's plans, management and general financial condition, that the securities issue proposed by the bank would be well received. It is strange that Wood Gundy, following meetings with these bodies, was able to report that there had been little discussion of loan portfolio problems in the bank. It was the calm before the storm for, as will be seen, by July and August there was little else to be talked about at the bank.

On 25 March, therefore, the only clear and immediate effect that could be seen from the CCB announcement was a liquidity problem brought about because the public would inevitably associate the two banks, and some of the depositors would take their moneys elsewhere. In fact, dealer deposits fell from $291M just before the CCB announcement to $121M by the end of April. At the same time, liquidity support from the Bank of Canada amounted to $85M by 29 April and grew to $540M by the end of August. It perhaps is not surprising that during this period retail deposits grew from $335M at the time of the CCB collapse to their all-time high of approximately $500M by 9 July.

Even in its last partial fiscal year the bank's loan portfolio continued to expand. An additional $250M of loans were booked from the beginning of the 1985 fiscal year to 31 August 1985, when the loan portfolio stood at $1.18B. Presumably, much of the 1985 loan growth was occasioned through workouts and refinancing. In the same period, however, the bank managed to earn some income, amounting before taxes to $2.5M. This was the result of taking into income $8M in "other income" which was mainly fees. From a cash point of view the bank was clearly in a loss position in 1985.

Of the loan portfolio at the end of the bank's existence, 43 of 1798 loans were over $5M, this small block representing 30 per cent of the book value of the whole portfolio. The portfolio remained heavily concentrated in Alberta and British Columbia, although the Toronto office had put out some $200M in loans. Real estate represented almost 45 per cent of the portfolio, an increase over the year before. Because of the accounting treatment accorded to the survival tactics adopted by management in that last fiscal period, it is difficult to discern the true characteristics of its banking operations in its last days.

Nevertheless, in all these difficulties, Northland proceeded with its capital issuance project of $35M in preference shares and debentures, and fatefully scheduled the closing on a date which turned out to be two days after the announcement of CCB's rescue program. It is not difficult to see that this timing was more unfortunate for the bank than for the potential purchasers of the new securities. Had the bank been able to take in $35M in new capital as originally planned (the ultimate issue was $16M of debentures and was issued privately) without the intervention of the CCB collapse, it would have been in a somewhat better position to continue its struggle for survival.

Shortly after the CCB announcement, Wood Gundy in its investigation of the possibility of a private securities issue, met with the auditors, the Inspector General, the Bank of Canada and others. It formed the conclusions that the auditors had not misled them or withheld any information, and that management was competent and trustworthy. Discussions with the Inspector General were more crucial. The Wood Gundy witnesses took notes of these discussions and from those notes and testimony by all concerned it appears that Wood Gundy had the impression that the CCB bailout was unique and that Northland Bank was not exposed to similar problems. The Inspector General did not give an opinion on the status of Northland's loan portfolio, write-offs, and so on, but rather referred Wood Gundy to the auditors. The Wood Gundy notes state in part, "The OIGB keeps an eye on Northland's restructured loans and the Epicon deals and the Northland's auditors have taken a very hard look at the bank's assets", "Difficulty with quality of earnings but have heard bank's plan to solve problem; will give bank time to see plans through". This might well have been taken by the underwriter as a clear signal that there was some problem at hand in the bank of sufficient gravity that the regulator either did not believe it could not be worked out or was willing to allow the launching of an attempted solution but had no full expectation of success. In short, the unclear comment might well have been read as a clear warning that if all did not go well the bank might be closed. However, the note continues, "Doesn't think that there is anything which would make it prudent not to close". This conversation occurred against the background of a recently completed annual inspection in which the bank's rating was changed from marginally satisfactory to unsatisfactory and in which apprehension about the bank's future was expressed by the inspectors. No firm conclusion had been made, however, by the OIGB as to whether the bank should be closed, supported, or put on some kind of performance probation. The notes taken by the underwriters and the testimony given by the Inspector General and the Assistant Inspector General would indicate that the regulator was anxious not to leave the impression that the underwriter should not proceed, as the result might well submerge the bank. The fear that an indecisive answer might be taken by the underwriter as an adverse opinion may have led the OIGB to say either too much or too little. On the other hand, witnesses from the OIGB took the position that they had raised flags in the interview which the underwriter should have seen and understood. According to Wood Gundy, the OIGB left the impression that it would not be imprudent to close the debenture transaction and they proceeded on the assumption that the OIGB was encouraging the transaction. The Assistant Inspector General left the meetings with a retrospective view that it might have been better to have said nothing rather than to have given a short guarded reply which lent itself to misunderstanding.

The Inspector General and the Assistant Inspector General at no time revealed that after the latest inspection of the bank the OIGB had classified this bank as "unsatisfactory". The Inspector General and his staff appearing before the Commission have throughout consistently taken the view that the OIGB relies upon the auditors in all financial matters. Indeed, once the financial statements have been certified without condition by the auditors, the Inspector General professes no interest in going behind that certificate whether or not subsequent events might be seen as putting the Inspector General on notice to inquire. Yet here the Inspector General expressed his own views and his staff expressed the OIGB's views to the underwriters without stating that they were based entirely in reliance upon that which the auditors had certified. To be consistent with the position taken before the

Commission, the OIGB would have simply referred the underwriters to the auditors for any financial information which they might require.

The underwriters examined one major loan recently booked by the bank, reviewed somewhat superficially nine of the largest loans in the bank, and had their legal counsel examine files relating to about 40 loans. In none of these examinations did the underwriters purport to bring to the review of the portfolio a banker's judgment, nor was a conscious effort made to reopen management's judgment on loan loss provisioning, loan classification, the treatment of interest, and so on. The debenture issue went to a handful of large subscribers, one of whom was a Credit Union with which the bank had had considerable dealings. A very complex series of transactions with the Credit Union at the time of the debenture issue is open to the interpretation that the bank itself thereby financed the purchase of $7.5M of its $16M debenture issue. It is not necessary to burden this report with the details of the transaction and the correspondence back and forth. In summary, the Credit Union seems to have transferred to the bank a serious loss potential in connection with a real estate development, and in return for that favour by the bank, agreed to subscribe for the bank's debentures. Much turns upon whether the transactions are fully related. The Credit Union treated as one transaction the various undertakings exchanged between the parties so that one obligation was linked to the next entitlement. The Commission considers, having examined the exchange of telexes and the loan documentation, that this is indeed the correct interpretation. In the result, the bank participated in funding its own program for the marketing of debt securities, and thereby, increased its capital which in turn allowed the bank to increase its deposit funding, all to the end of increasing the permitted size of the loan portfolio. The bank had financed part of its own growth. The proceeds of this debenture issue were ranked by the OIGB standards as part of the bank's capital. Because a bank, through the leverage ratios, can create loan assets in a permitted multiple of its capital base, the capital base is a very important element in the bank's financial structure. At a reasonable leverage ratio of 20 to 1, it can be readily appreciated that a small addition to the bank's capital opens up a considerable horizon for loan portfolio enlargement. Thus it is of considerable importance that the practice known as "cycling" be prohibited because it allows a bank to determine its own maximum level of outstanding loan assets.

The Inspector General is indeed in an invidious position when as regulator he is called upon to opine on the advisability of a capital issue. It is, of course, in the interests of the bank to take in new capital so as to permit its growth or the establishment of lower and more stable ratios between debt and equity, and assets and capital. The statute puts a burden upon the regulator to pass upon invitations by banks to the public to subscribe to its securities. The Inspector General cannot discharge that duty by complete silence. On the other hand there is no duty in the Inspector General to give any assurances to underwriters that the issuer of the securities (the bank) will survive for the lifetime of the indebtedness and be able to repay it. This is so especially where, as here, the issue is a private placement not accompanied by a prospectus. Indeed the *Bank Act* prohibits the the release of information by the regulator to third parties. It would have been the wiser course for the OIGB officers to have refrained from expressing any conclusions which could be taken to connote advice or encouragement. To supply part of the information in the possession of the OIGB, but not other information which might reasonably be taken to put a serious qualification upon the disclosed information, is a much less satisfactory position for the public regulator to assume.

In the 1984 inspection, the OIGB had rated the bank "marginally satisfactory". By the time of the 1985 inspection, the OIGB staff had started to become skeptical about the quality of Northland's loan portfolio. Accordingly, it was proposed that the Inspector General second to his inspection team two bankers from the major Canadian banks. To this proposal the management of Northland Bank strenuously objected, for the expressed reason that they felt it signalled a change in the basic approach or attitude of the OIGB to the bank. Management sensed that this might foretell a departure from the going concern "long-term value" concept, a change which management must by this time have been aware would be fatal to the bank. The bank won the argument, and the proposal to add seconded bankers to the team was dropped. By May 1985, the OIGB internal memoranda directing its inspection staff revealed at last an acute awareness in the OIGB of the problems in the bank concerning asset growth (meaning loan growth) funded in part by Bank of Canada liquidity advances, a decrease in the bank's interest spread, a considerable increase in fee income, the timeliness of the management's recognition of specific loan losses, and capitalized interest, which had reached $2.4M in the last fiscal period to the Inspector General's knowledge.

This was the first OIGB inspection report to raise a serious signal of the bank's impending death. It stated in part: "We believe the bank may require some form of assistance to survive". The inspectors also recognized for the first time the strong probability that a number of poor quality loans were maintained in stable condition simply by the bank's failure to declare them to be NPL. The OIGB also, for the first time in writing, revealed an awareness or conviction that the end of the reasonable period for testing workout loan values had arrived and that something had to be done to reduce the difference between the carried value in the financial statements and the real underlying value of the portfolio assets. The report stated in part: "... the biggest concern is whether the strategy of growth and loan workout was the right one".

Notwithstanding these stern realizations, however, the letter from the Inspector General to the Minister of State (Finance) of 5 June 1985, although reporting on the workout approach and the other concerns already mentioned, contained no warning that the bank would need outside help if it were to survive. This was the very information and advice which the responsible Minister required to perform the duty of the executive branch of government in implementing and enforcing the *Bank Act*. Fortunately, by this stage, events had developed their own momentum. This serious omission may have delayed executive action only for a few weeks.

Up until June 1985, Northland Bank had been relying upon credit extended to it by the major banks. These interbank accommodations were coming to an end. In the course of its contacts with these banks, Northland Bank came to realize that at least some of them would require a monitoring arrangement if the credit theretofore granted was to be extended. Another suggestion was that if the "Big 5" were to extend the facility, some hypothecation of assets to them would be required, and this of course would collide with the Bank of Canada's claim of prior rights as a lender of last resort. There was, of course, a practical consideration as well. The lending rates of the Bank of Canada were about one-half of one per cent lower than the rates extended to Northland Bank by the major banks. Minutes of a meeting in May between a representative of the Bank of Canada and Neapole indicate that Northland intended to resist any condition that advances from the major banks would carry with them the right to inspect. This is a continuation of Northland's attitude to outside bank inspectors having access to the loan portfolio during the annual OIGB inspection. Neapole was very much aware that extensive borrowing from the Bank of Canada would deter other depositors, because every time the Bank of Canada made a liquidity advance it took some more security. Further harm would be done as the state of the account with the Bank of Canada was published in the *Canada Gazette*. While it is difficult to be certain as to why, in the face of these conflicting considerations, Northland switched from the Big 5 to the Bank of Canada for its exclusive liquidity support, it is reasonable to conclude that Northland Bank had a justifiable fear of big bank scrutiny of its loan assets in their then state. In fact, later inspections of Northland's loan portfolio by representatives of the major banks led all the examiners to form the opinion that extensive write-offs were required and in many cases long overdue.

In July, changes in the attitude of the OIGB began to become more evident. In early July, Adamsons, an OIGB employee formerly with the Canadian Imperial Bank of Commerce, was sent to examine more intensively the quality of the loan portfolio. Meetings took place between the Inspector General and the bank auditors, and the Inspector General and Bank of Canada officials, and in early July a memorandum in the OIGB recorded: "The view about workout time must change and write-downs occur". The bank was persuaded to limit loan growth and not to use Bank of Canada advances for that purpose. Unfortunately, to the dread of any banker, newspaper articles began to appear in mid-July in which the shaky condition of Northland Bank was discussed. A new run on the deposits of the bank began, this time including some retail deposits. A public vote of confidence by the Inspector General was to no avail.

This liquidity crisis precipitated a meeting on 20 July of Neapole and Fortier, the Governor and officers from the Bank of Canada, the Inspector General and one or two of his officers, and members of the staff of the Department of Finance. Neapole advanced a plan for the major reconstruction of the bank as a solution "to the confidence problem it was experiencing". Two other banks, including CCB, had recently taken write-downs on their portfolios and, Neapole believed, the market wanted to see Northland do the same. This proposal involved the sale or public issue of common stock, an issue of preferred stock to be guaranteed by Alberta, and a sale to the federal government of a substantial part of the loan portfolio said to consist of inferior loans. Altogether this amounted to an infusion of some $300M into the bank. Management maintained that its proposal was not an acknowledgement of deterioration of the loan portfolio, and did not presage an insolvency crisis. According to the minutes, the Bank of Canada still believed that Northland's condition was one of liquidity resulting from a perception problem and, although serious losses of income had been encountered and the bank needed help, that it was not in the same condition as CCB.

In the meantime, the OIGB appeared to be showing signs of extreme wariness about Northland. This may have been induced in part by the state of shock in the OIGB which the collapse of CCB had earlier produced. Indeed, the Inspector General indicated that 20 July was a meeting of crucial importance and that Neapole's confessions at that meeting paralleled McLaughlan's exposé of the CCB's serious internal condition on 14 March. In the Inspector General's words, "... there is an urgent problem here that has to be dealt with and it is a problem that goes beyond just a pure liquidity problem". Burdened by the recurring difficulties encountered in the CCB bailout design, implementation and execution, and faced with the strong intimations coming from

Northland of parallel difficulties, the Inspector General began to swing around to a recognition that the Northland Bank was on its last legs.

By 1 August, when a further meeting was held in Ottawa, liquidity advances from the Bank of Canada stood at $380M. More significantly, Adamsons had reported to the OIGB, by way of a brief summary, his preliminary findings that write-offs, write-downs, and reversals of interest on accounts totalling some $13M had to be undertaken in respect of the $525M of Northland Bank loans which he had examined out of a total portfolio of about $1.2B. He also criticized the lending practices existing in the bank. Management presented another proposal at this meeting for the restructuring of the bank which involved the sale of assets to a new company to be owned by Messrs. Dixon and Derrickson (who shall be introduced shortly), which sale would be financed initially by the bank and subsequently syndicated to a federal government agency, sale of other loans recognized to be soft to Epicon, and the use of strip bonds as a long-term insurance for the repayment to the bank of the principal sum of the loan to Epicon thereby avoiding, in management's view, any write-downs. As will be seen, this became a feature of the proposals of bank management in the dying days of Northland Bank. The only result which came from the meeting of 1 August was an agreement by the Bank of Canada to postpone until 24 August the publication of liquidity advances in the Canada Gazette because Fortier, speaking for management, indicated to the meeting that such disclosure at this time would "kill off" the bank. The Adamsons preliminary report together with other comments at this meeting awakened in the Bank of Canada a recognition that more than liquidity aches and pains were present in Northland. The Governor's notes refer to a remark made by the Inspector General: "... the bank had played games by taking fees into income rather than amortizing them over the life of a loan and had thus overstated current profits at the expense of the future". The Inspector General, while indicating privately to the Governor that he had lost confidence in Northland's management, asked the bank to seek out a possible merger candidate and proposed the National Bank. Neapole's response was that the problem had become political. The bailout program for CCB had been ill-advised, poorly designed, and badly executed. In his words it had produced an "Edsel". In Neapole's view, this had produced in the public mind the perception that Northland Bank and CCB were in similar condition, and this had hurt the Northland Bank.

It certainly appears from the internal records in the OIGB that by this time, having regard to the seriously declining condition of CCB, the regulators had come to see these two banks as in the same class and category. The Minister of State (Finance), who was present at this meeting, acknowledged that any adverse events in CCB at this time, particularly its failure, would have an impact on Northland, but stoutly denied that any decision had been made by the Government that if one bank went the other must fail as well so that the political heat could be taken at the one time for one event.

The OIGB's continued examination of the internal records of the bank produced the final cold recognition by at least one of the inspectors that when the bank adopted "a workout situation" for a loan, the auditors acquiesced in the use of future values in assessing its worth and that of the underlying security, with all the fateful results that entailed as regards postponement of provisioning and continuation of the recognition of accrued interest. This inspector further noted that the auditors used current values of loans and loan security only when a liquidation approach was adopted by the bank. All of this was a much delayed recognition by the inspection staff despite the numerous signals in the reports, minutes, records, and conversations with management and auditors regarding these practices over the preceding two years. At about the same time, the auditors responded to the Inspector General's concerns: "We not only understand your concern, we also share your concern. Given the facts the concern is fully founded". This apparent evidence of a final awakening by the auditors was, however, explained in testimony as only meaning that the auditors were concerned if the Inspector General was concerned, but that the words did not mean what they otherwise plainly indicated. Management and the bank's external auditors maintained a solid front on these practices to the very end of the bank and in the face of all evidence to the contrary.

As a final last desperate fling at solution by way of a private bailout in contrast to the mixture of public and private bailout in CCB, Northland's management produced a proposal which is referred to in the testimony at some length as the Rondix deal. On 16 August 1985, it was presented to the OIGB inspection staff. It is not without significance that Willson, attending as Chairman of the Board at that general meeting, declined to join in the subsequent special meeting of the technical staffs to examine the Rondix proposal on the grounds that he was not "a banker".

The two principals of Rondix were Ronald Derrickson and Gordon Dixon. Chief Derrickson was a director of Northland until 22 August 1985, the date of the Board meeting at which Northland's directors authorized the Rondix transaction. Derrickson's resignation was tendered immediately before the authorizing resolution. Derrickson was also the principal of corporations which already had loans from Northland Bank. Dixon, a Calgary lawyer, had a number of dealings with Northland Bank, including a recently restructured loan known in the hearings as CA12. His law partner, Ritchey Love, was a Northland Bank director. Love absented himself from the deliberations of the Board with respect to Rondix.

The transaction is complex and detailed but the fundamental structure may be summarized as follows. Northland Bank was to sell $100M of interests in poorly performing assets at book value to Rondix. The $100M was comprised of about $16M in property owned by Northland Bank as a result of foreclosures, about $25M in loan assets to be sold outright, and approximately $57M in junior fully subordinated beneficial interests in a number of other Northland Bank loans. The loan transactions involved about 75 loan accounts with a total face value of approximately $205M, the bank retaining an interest in some of the loans. Rondix would manage all the loans involved. In addition, Rondix would purchase for $25M stripped Government of Canada bonds maturing in 15 years, with a maturity value totalling $125M. The purchases by Rondix were to be financed by an interest-free 15-year loan by Northland Bank to Rondix in the amount of $125M. In addition, the bank would grant a further interest-free $6.25M loan to Rondix, $5M of which was to be used as operating capital by Rondix, and $1.25M to purchase a second group of stripped Government of Canada bonds maturing in 15 years with a face value of $6.25M. The total credit facility provided by Northland Bank to Rondix was thus a $131.25M interest-free loan, maturing in 15 years. Actual cash laid out by the bank was $31.25M, the cost of purchasing all the bonds and the provision of operating capital. As security for the loan, Northland took back a pledge on all the assets and a pledge of the stripped bonds.

The purpose of the strip bond feature is of some importance. As the face value of the bonds equalled the loans made by the bank to Rondix, the repayment of those loans, 15 years hence, was assured. According to both Guenette and Adamsons, the purpose of the Rondix loan was to allow Northland to amortize losses over a 15-year period. Rondix also agreed to pledge "additional security" of certain property alleged to be valued at $7.2M. Most of that property, according to Touche Ross, was already financed and secured to Northland. Indeed some of that property was in the process of reappraisal which was expected to increase its value and result in some equity over and above Northland financing. There is no evidence of circumstances tending to increase the value of that property, which had been restructured only a year or so earlier. Derrickson and Dixon were to manage the assets in return for a fee of $1M per year. Northland and Rondix would share equally in any recovery on the assets. If there were a complete recovery on each asset, Rondix's principals would receive $50M.

The transaction (and another one of a somewhat similar nature) was explained to Macpherson and Adamsons of the OIGB during the meeting of 16 August 1985. They did not offer any opinion, either positive or negative, on the transaction at that time. The Rondix deal was presented to the Board of Directors and approved on 22 August 1985. Neither management nor the directors insisted on an opinion of the bank's auditors as to the accounting treatment the bank could employ with respect to the loan to Rondix, although the ability to carry the entire $131.25M loan at its face value on the Northland Bank books was crucial to the success of the transaction. In fact, so far as Northland Bank was concerned, this was the *raison d'être* for the transaction. Northland Bank was seeking to stretch to an absurd degree the rule that the carrying value of the loan need not take into account the time value of money. In the circumstances, it strains credulity and must be seen as a measure of the desperation of Northland's management and the ineffectiveness of its directors that no audit opinion was obtained or required in advance of approval.

Morrison, then the curator, and Adamsons did not accept the proposition that the Rondix deal was an appropriate transaction. Adamsons concluded that "the rollover of the loan assets and properties to a new corporate entity does not materially improve the Northland Bank's position. ..." He also pointed out that Rondix had provided no down payment. Morrison, the liquidator, readily agreed that Rondix was in effect "a layer of paint" intended to transform bad assets of Northland into a good loan to Rondix. In his view, the intervention of Rondix was of little or no value to Northland, which could have purchased the strip bonds by way of insurance against ultimate losses as readily itself as indirectly through Rondix. The later review by the National Bank reflected a similar assessment.

An opinion on the Rondix transaction was obtained by the CDIC from Price Waterhouse in January 1986. Price Waterhouse's opinion was to the effect that the transaction would not allow Northland Bank to amortize its losses over the 15-year period. Under the accounting treatment proposed by Northland, according to Price Waterhouse, the sale proceeds of the transaction and the amount of the loan recorded in Northland's books would be improperly overstated if carried at face value. In the result, even assuming a best case scenario, Northland Bank would have to recognize a loss of slightly over $50M, and if the assets were only 50 per cent collectable, the loss to be recognized would be $75M.

The risk undertaken by management is astounding. The assets to be transferred to Rondix were classified as loan substitutes, Epicon assets, nonproductive, and loans with a high probability of going nonproductive. These were not healthy assets. Neapole said, in effect, that no one knew how successful Rondix would be; the top side was the $50M fee, the bottom was zero, and the actual degree of success was a function of "success and market conditions, the efforts and so on applied over the long pull". The danger of receiving an unfavourable accounting opinion is graphically illustrated by the following exchange about the Price Waterhouse opinion between Mr. Scott, counsel for the CDIC, and Mr. Neapole:

> Q.: And if it worked out in the worst case, not even in the worst case, if it only worked 25 per cent, you would not have any capital reserves, you would be in the hole 18 million?
>
> A: (Neapole) I have seen the opinion and I understand the arithmetic.
>
> Q.: The point is that if you had got that opinion from your accountants from the time of your 1985 financials, your bank was finished.
>
> A: (Neapole) Assuming that the regulators and accountants were all in accord that that was the appropriate accounting treatment, I guess you could argue that, yes.
>
> Q: Not you could argue, that was going to be the case?
>
> A: (Neapole) Clearly. ... There is no mystery.

There is no doubt that the Rondix transaction did nothing for OIGB confidence in management. The speed at which the proposal was put in place, the size of the deal, the lack of an accounting opinion, the failure to inform the Bank of Canada about the sale of already hypothecated assets, the short period to closing, and the proposed effect of the transaction on Northland Bank's financial statements all showed the desperation of Northland management. In short, the proposal forced the hand of the regulators. Neapole, in testimony, acknowledged that the "indulgence" of the regulators would be required. It is difficult to envision how Northland Bank could hope to carry a no-interest loan of $131.25M for 15 years. It may be that at this stage Northland management had little to lose as the closure handwriting was on the wall.

5. Appointment of the Curator

In the eyes of the Inspector General, the Rondix proposal represented an accurate measure of the desperation experienced by management in keeping the bank going at this time. He concluded that there were but two alternatives. Northland could be merged with another bank (which would really take the form of a liquidation since it was of doubtful attraction to a major Canadian bank), or it could be liquidated directly.

The Inspector General had already indicated to management that National was the only possible merger candidate. National's management, on being approached, examined the Northland Bank portfolio through a four-man team and concluded that a write-off of about $300M or about 25 per cent of the value of the portfolio would be required. In fact, the National inspection staff were of the view, after two days' inspection, that only about $500M of the $1.2B loans in the portfolio were in normal bank condition. The National Bank stated that they were not interested in a merger. While management attacked the National Bank's approach to the valuation task with vigour, the fact remains that its inspectors were highly qualified bankers, and indeed, the National Bank had successfully merged in the past with other banks. Its conclusions about Northland's loan values, and the general condition of the bank, are far from irrelevant. They join a stream of similar valuations, analyses and conclusions by a large group of qualified persons.

The Inspector General reported to the Minister of State (Finance) that a merger was not available, and went on to report that if Northland Bank were liquidated there would probably be a substantial negative net worth amounting on a fast liquidation basis to some $300M, which was in line with both the National Bank appraisal and Adamsons' final report. The Adamsons report concluded that the bank's "present situation is untenable ... the bank's management, both past and present, has laid the groundwork for its present difficulties. ..." The Inspector General recommended to the Minister that curators be placed in both Northland Bank and CCB. Last ditch attempts to find another solution were made on 28 August at a meeting in Ottawa of Willson and Fortier from the Northland Bank, the Minister of State (Finance), the Inspector General, and their advisors.

On 29 August the Deputy Minister of Finance reported to both Ministers that he estimated the losses on liquidation of Northland Bank would be $300M (the same as and probably drawn from the OIGB report), and that a support package would cost over $250M. In passing, it was observed in this that the CCB bailout experience did not encourage another attempt here. This report, the Minister of State (Finance) concluded, was the last salvo which sank the Northland Bank.

Up to this time the OIGB had not disclosed to the management of the bank its intention to appoint a curator or that the bank was one way or another going to cease operations. This silence by the regulator was explained by Kennett:

> For fear we might open up the possibility of abuse, insider information and insider abuse. We wanted the situation to remain in some kind of normalcy until we were prepared to act.

The decision was communicated to management on 31 August 1985. The curator was appointed on 1 September 1985, although at that time it was agreed by the Government to accord to the bank a limited period of time in which to restructure itself with another financial institution.

The difficulties which surrounded the terms employed in the *Bank Act* concerning the actual termination of the operations of the bank have already been mentioned in connection with CCB in Chapter 4. It may be, of course, that the Governor of the Bank of Canada was in error when he stated that the Inspector General "really could not use the *Bank Act* definition of insolvency in his letter to me as long as I was funding the bank". A much sounder solution to the problem is a revision of the *Bank Act* rather than a finely balanced argument as to what the present provision of the *Bank Act* means. This is discussed in Chapter 6.

Immediately upon the curator's appointment, he commenced to review the bank's loan portfolio, and for this purpose, he engaged the assistance of Royal Bank credit personnel. By 27 September, he was able to report to the Inspector General and the Minister of State (Finance) that the portfolio did not reflect adequate provisions for losses, and accordingly, "it appears to us that the amount required to give recognition to such loan losses would exceed the amount of Northland's capital base ... [and] ... such accounts would show that the liabilities of Northland exceed its assets. ..." By almost any test, and certainly including the test at common law, the bank was insolvent on 1 September 1985 in the view of the curator and those reporting to him. Accordingly, he recommended an orderly liquidation. In the meantime, the special adviser appointed by the Minister to assist in the search for some financial institution which might bring about a reorganization of the bank's affairs was unable to find any solution which he could recommend to the Minister.

To all these processes, management of the bank took violent objection. In their view the bank was not insolvent and its troubles were due to events at CCB, particularly the events surrounding the design and performance of the bailout in which Northland Bank had not been invited to participate. Management had, in their view, provided the Government with a workable solution in the form of the Rondix deal, or in the alternative, some other form of bailout analogous to that in CCB.

It is clear that by this time the CCB pattern of bailout, even if it were appropriate to Northland Bank, could not have been engineered because the private sector involvement would have been impossible to organize. No doubt there was also a new wariness on the part of the political element in the process of anything approaching Government participation in a bailout by reason of the experience in CCB. The overriding consideration, however, appears to have been the appreciation of the fact that the bank was insolvent and no help would likely be forthcoming from the other banks.

The decline of Northland Bank into its curatorship status and eventual liquidation climaxed on 1 September. Its existence immediately prior to that had been precarious and was based entirely on the regulator's (and indeed the bank's auditors') willingness to allow the bank to unilaterally salvage a loan from NPL classification by the adoption of a workout strategy in any of a variety of forms, again unilaterally selected by the bank. As the Inspector General and his staff hardened in their view of these workouts, and as time went by without production of tangible results, these survival tactics, theretofore considered to hold promise of success, fell into disrepute. There can be no reasonable doubt that when all the reports and studies then at hand were reviewed, this bank was insolvent by any of the conventional definitions. The report of 27 September was a final confirmation of this fact.

Whether these survival tactics were thrust on management of necessity by circumstances existing prior to the introduction of this new management is not relevant to the final determination as to whether the bank was properly put in the custody of the curator on 1 September 1985. Neither, however, does it necessarily follow that it was bad management in the bank in 1984-1985 which precipitated its ultimate liquidation. Again, the timing of the curatorship depended upon the time of realization by the Inspector General that the bank was insolvent. Certainly one thing is clear, and that is, the closer the Inspector General got to an eyeball examination of the loan portfolio, the closer the bank came, in his view, to liquidation. Other sources of information available prior to that time had, for some reason, not impelled the Inspector General to the conclusion of insolvency. The Adamsons report and the National Bank inspection seem to have produced a belief in the OIGB that an actual examination of the bank's loans by banking credit officers had revealed a much more serious condition than had been made clear through management, the external auditors, and indeed through its own inspections.

B. EVALUATION OF THE SUPERVISORY PROCESS

1. Management

Several questions remain to be discussed in relation to Northland management. What were the faults, if any, of management in creating the conditions which led to the failure of the bank? To what extent did management contribute to the lack of reaction by the auditors and the regulator to the true state of Northland's financial condition? The record reveals, as we have seen, that in the pre-Neapole management stage imprudent if not improper lending practices and weak constantly changing management created a loan portfolio the ultimate decay of which led to the fall of the bank. The Neapole era, on the record gathered by this Inquiry, saw a continuation of that type of management which added to the difficulties in the loan portfolio. More characteristic of that era, however, was the design and execution of unconventional banking policies and practices and related accounting treatment which disguised, masked or suppressed a correct and full view of the financial situation in the bank, all to the end of buying time to allow the introduction of remedial measures which might save the bank. This was the epoch of survival techniques openly devised and installed, in the main, for the avowed purpose of restoring market confidence and buying time. Time was needed, for example, to shift from volatile wholesale money market deposits to retail deposits, and to dilute the proportion of NPLs in the loan portfolio by the granting of new loans.

There is no doubt that the design and the business plan early adopted by the bank, as it set out on the road as a conventional bank, was inherently risky, was proven to be improvident, and led to a failure which, if not already inevitable, was made so by this plan. There is serious doubt as to whether a market niche, as seen by the bank's planners, ever existed. If collapse were not inevitable by design, it was made so by management's choice of business strategy which made the bank vulnerable to the inevitable cycles of the businesses and region with which and in which it operated. The constant changes in the senior positions delayed fatally the formation and consolidation of an experienced, professional, and cohesive team. In a small bank this must surely be, from all that has been seen in this Inquiry, a condition precedent to survival. In the opening years of this small bank, this management produced a principal asset, its loan portfolio, of very doubtful quality. The onset of the recession in Alberta caught the bank without any proper, balanced, and experienced professional banking management in place. The evidence indicates that very early in the Alberta recession, and clearly by early fiscal 1983, the bank was insolvent in the sense that its liabilities exceeded the true worth of its assets in the market then existing in its region of operations. This is what the Prisco team probably, and the Neapole team certainly, inherited. Either the defective loan assets or the serious and lengthy recession might have brought the bank down. Their combination produced an atmosphere of inevitability, at least in retrospect.

Recognizing these realities, Neapole, Fortier *et al.* consciously adopted a management style and a banking policy which, while it held some promise of buying time to bring the bank around, had the effect of increasing the banking problems and the unsatisfactory condition of the outstanding loans. The most that can be said for this decision was that the bank had nothing to lose from adopting a wide-scale practice of workouts, rapid loan growth and all that flowed therefrom, since the alternative was simply to allow the bank to succumb to insolvency. To this, one exception should be made. The prospect of a worthwhile merger was much greater in 1982-83 than by 1985. This lost opportunity may have been the price of the gamble taken by the survival or delaying tactics. The evidence indicates that conventional banking and accounting techniques applied from early 1983 onward would certainly have laid bare a situation that would have frightened off depositors and investors, and brought about a run on the bank's deposits with the inevitable consequence of bank failure. The criticism that inevitably falls out of an examination of the documents and testimonial evidence is that the bank crossed the line of propriety frequently, consistently, and eventually, permanently in its operational decisions, in its workout strategy, and in all the decisions along that path. Once these decisions were in place, management set out on a program to persuade the two potential objectors in its path, the auditors and the Inspector General, to go along with these strategies on the basis that the workouts would create value where value no longer existed in the loan portfolio, and would thus protect the income statement and balance sheet. In short, management was saying, these practices are acceptable and no one is being hurt by them. Therefore the auditors and the regulators should approve, or at least not interfere. They did both. None of this could have been detected by a reader of the financial statements from fiscal year 1982 onwards. Eventually, these financial statements verged into fiction and the price of survival from that point on was paid not by management but by those who dealt with the bank, and ultimately, the public.

The various practices adopted by Northland management from 1983 onwards were, in the main, predicated on a fortress mentality that if outsiders could be held at bay by one accounting treatment or another, which would shore up the balance sheet, and income statement, good times would return, values would flow back into the bank's balance sheet, and the bank would survive. The process reduced itself to a test of nerves to see how far these experiments could be carried by management without the necessity of revealing the true financial condition of the bank as measured by both its earnings and its assets. The extent and the success of management in holding the auditors and the Inspector General in line is topped by the fact that the Chairman of the Board, Willson himself, apparently did not fully appreciate the magnitude of the reach, and the consequences of management's decision to undertake novel, though energetic and imaginative programs of loan reconstruction. It never seemed to dawn upon the Chairman, or indeed several other Board members, that the valuation assumption underlying all these managerial decisions led to an inflated set of values which inevitably destroyed the accuracy of the financial statements. Indeed, the continued rollover of middle management through the Neapole era to the dying days of the bank may have been due in part to the difficulty of securing and retaining the services of experienced bank middle managers once they realized the consequences of the implementation and continuation of the workout and related strategies to the disregard of conventional banking approaches. They were perilous practices, adopted of necessity, and their success could at best be a deferral of a collapse predestined by all the mistakes that went before.

More will be said shortly about the position in all this of the external auditors, the directors, and the Inspector General. At the moment, it is sufficient to observe that while there may have been varying degrees of awareness of the tactics and all their infinite shadings, designed and introduced by management, there was no clear appreciation of the results these tactics would produce. Certainly this was so until early 1985.

Throughout this period, the different sectors of the public associated with the bank did not seem to appreciate what was happening in the bank. Neapole, at the end, was able to state that:

> I think our 1984 report was the first time that we made a concerted effort to tell the outside world what we thought we were and what we were trying to be and evolved into. I think we described ourselves at that point as a hybrid kind of a combination traditional bank and private bank, merchant bank. We thought there was a role for that kind of an [sic] institution, and we were doing our best to fill it.

It should be observed in passing, however, that the 1984 financial statements did not reveal, by themselves, the essential fact that in the Epicon grand scale workout, the dispositions of which the bank spoke so proudly, were in turn financed entirely by the bank. The bad loans never left the bank. They just changed their names. In short, management was digging the hole deeper. It is remarkable that even the Chairman of the

Board did not see this fatal characteristic of such activities of Epicon, nor apparently did the Inspector General.

2. The Internal Inspection System

The internal inspector in the Northland Bank acted as a radiator of information up through senior management and, for a time, out to the external auditors, the directors, and the Audit Committee. The internal inspector's task of classifying loans and reviewing loan provisioning did not last long in the Neapole era. The internal inspector was directed to confine himself to matters of which the senior management was unaware (mostly loan administration and accounting) and not to deal with the loan portfolio where, in a small bank, management needed no assistance as they were already well aware of its details. In short, it was made known to the Chief Inspector that loan loss provisioning was the exclusive preserve of management and not for him.

Stan Willy, the Chief Inspector from February to August 1983, was directed not to include assessments of the loan portfolio in his reports. There is also some evidence that similar pressure was placed on Willy's predecessor after Prisco's departure. Iain McLeod, who was internal inspector after Willy, was asked not to continue the practice of circulating summaries of the classification of the loan portfolio which he had theretofore distributed to senior management, the auditors, and the Audit Committee. McLeod concluded that this directive was issued because his reports were causing troubles for senior management in discussing loan loss provisioning and income recognition with the Audit Committee of the Board or with the external auditors, or both. From that time forward, the Audit Committee did not discuss the internal inspector's findings with him, and the auditors considered the inspection function inside the bank was too limited to be of any assistance in conducting the annual audit. Notably, while the Audit Committee was aware of the change in McLeod's format, its members viewed the reports as primarily useful to management and the auditors. It took no steps to determine why the format had changed.

It is a tribute to the dedication of the last Chief Inspector, McLeod, that faced with these limitations from senior management, he continued to analyze, classify, and report to that management. In the course of this work he classified a total of 40 per cent of the loans at the branch level as unsatisfactory or worse. He did not, however, send these reports to the destinations described earlier, nor did he deliver them to the Inspector General, but he did discuss the essential features of his work with the OIGB staff during their inspection of the bank. There is nothing, of course, in the *Bank Act* entitling the internal inspector to take it upon himself to make confessions on behalf of the bank to the Inspector General concerning the state of the loan portfolio. Also, one must bear in mind that the Chairman of the Audit Committee and the external auditors had access at all times to all of McLeod's work and files. Either the Chairman of the Audit Committee or the external auditors could have uncovered all of this information and, in the case of the Audit Committee at least, could have confronted management.

This much can be said for the position taken by management on this question: the needs of a small bank are not those of a large bank. Neapole had worked in both. The layers of management are few and the distance between the top level of the bank and those conducting its operations in the front line is short. The senior executives are necessarily much more aware in a small bank of individual loans than in a major bank. Thus, the need of management for some of this information is different in a small bank. However, this overlooks the essential need for and purpose of the internal inspection service, which Mr. R. Frazee, as Chairman of the Royal Bank of Canada, said allowed him to sleep at nights. A new small bank is much more vulnerable to one bad loan than is a large bank. A small group of bad loans can sink a new small bank. The inspection system is a constant process and a check visible to the bank staff and especially nonmanagement members of the Board who have no other independent sources of information on lending and loan management practices. Without this, the build-up of pressure from unproductive loan assets may reach lethal proportions before bank management and Board members, or at least the members of the Audit Committee, become aware of the problem, and make repairs. In Northland, however, the troubles were so pervasive, deep, and life-threatening to the bank by the time Neapole took office that the contribution of the inspection system, and its defects, were much diminished in scale as compared to the other problems of the bank.

3. The Board of Directors

A total of 42 persons were members of the Board in the bank's ten year history, and only five of these directors were present for the duration. The evidence received in the Inquiry and the documents' analysis throw up two salient features of the Board's operations. It relied very heavily, and throughout the life of the bank, on the expertise of the people in charge of the operations of the bank. The directors also relied on the auditors to check on actions taken by management. Certainly, whenever the auditors supported management, the directors were at once satisfied. There seems in all this to have been little left for the Board itself to do as an element in the government of the corporation.

R.A. Willson, the long-time Chairman, appears to have had a profound influence upon the Board's deliberations. This was perhaps natural. He prepared the study which led to the formation of the bank, was its first Chairman and was the CEO for more than half the life of the bank. He alone was in executive and board positions throughout the history of the bank. On the other hand, the Board seemed entirely impervious to warnings expressed, some very loudly, by Messrs. Prisco, Stephenson, Siebens, Willy, McLeod and Tourigny, the financial adviser whose report was presented to the Board by Siebens. None of these warnings seemed to have been translated by the Board into any action with reference to the quality of management which is, of course, the ultimate and prime responsibility of a board of directors.

It would be remiss to omit consideration of the positive signals the Board received. In 1979, most of the concerns expressed by the Inspector General were systems-related, expressed in the context of start-up problems in a new bank. However, by 1982 a number of concerns were being raised by the OIGB. For example, on 22 October 1982, OIGB officers Grant and d'Entremont met with Willson and Green. The officers made the following points among others:

1. disappointed that the Board had not been kept fully aware of the deteriorating loan situation, although apparently, steps were being taken to solve this problem.
2. concerned about the extent of accrued interest, capitalized interest, and whether or not collateral values were up to date and realistic.

Some idea of the signals which the OIGB would have conveyed to the directors (via the Chairman) can be gained from the testimony of Kennett regarding the early days of the bank:

> ... In the early days of this bank, there were a number of problems. ... There were problems with the accounting; there were problems to some degree in relation to changing management. I recall in the early days being concerned because the bank did not seem to be developing in the way that was suggested by the entrepreneurs who had established the bank when they were before Parliament to receive their Charters.
>
> So, there were a number of issues that were raised from time to time.
>
> On the other hand, I think it is fair to say that my recollection of those early days is that we were not unduly concerned about the lending practices of the bank....
>
> Our impression was that those lending practices were reasonably conservative ... so that we felt, in the circumstances, that they were being reasonably careful.

As to management the Inspector General observed:

> ... Mr. Willson himself did not have a banking background. He generally had people working for him who did. The first President, Hugh Wilson, was a

> banker with considerable experience. Mr. Eric Young was also a banker with considerable experience. Walter Prisco had a good reputation as a banker.
>
> While we felt that the group was not particularly dynamic, it did have an adequate banking background to run the bank in a reasonable way, and our feeling, as I said before in the very early years was that it was running itself in a fairly conservative fashion.

The directors also received signals from the auditors which provided a measure of reassurance. Although the auditors continually expressed their concern with the bank's lack of control, they advised the Audit Committee at the November 1979 meeting that they were satisfied that the bank generally took a prudent approach on all loans. There is a similar reference in the Audit Committee minutes for 1 December 1982, where it is reported that the auditors had done extensive work on the portfolio and were satisfied that loan loss provisions were adequate. And, of course, the bank received an unqualified opinion on its financial statements every year.

In the Neapole years, the Board was well aware in general terms of management's workout strategy. Willson noted that Neapole had explained his strategy to the entire Board. Johnstone described the Epicon concept, expressed by Neapole to be the most important part of the bank's workout strategy, as a prudent plan. Indeed, at the Board meeting held on 26 May 1983, when the Epicon proposal was put to the Board, management advised that the real estate subsidiary was one part of a total strategy and would provide the necessary expertise to deal with problem loans. The Board was told that management's initial concern was with how best to strengthen the bank by adding value to the existing portfolio in the shortest possible time.

The Board received rosy reports from management regarding workout loans. At the 2 November 1983 meeting, management discussed a $19M loan, and reported that the bank could proceed to syndication of the loan, which was expected by February 1984, with restoration of Northland's position by April or May 1984. This never occurred. The loan referred to in the hearings as CA12 was discussed. It was another "bad" loan, but "management was engaged in a very concrete process of restructuring financing" which it hoped to have completed and documented by January 1984. In another loan, in the Cayman Islands, the Board was told that management was "optimistic" that the loan might be paid out as early as the spring of 1984. This also never occurred. When all this discussion was completed Mr. D. Skagen, a director, moved the Board to recognize the "magnificent job" done by management on the various projects underway. And, at the 23 May 1984 Board meeting, the Board received a short report regarding the annual inspection of the Inspector General:

> The Chairman reported briefly on the annual inspection by the Inspector General, who had expressed satisfaction with the significantly stronger position of the bank, particularly in lending operations. He concurred with the bank's recognition of liquidity as the current top priority.

The Board was continually advised by management of its success in the workout strategy. For example, at the Board meeting of 21 August 1984 it was reported:

> ... Loan production had exceeded forecast by approximately $150 million. Nonproductive assets projected at $75.2 million at October, 1984 were currently at $71 million, with the decline being a direct result of SMART activity. Reduction had occurred in all regions ... In reply to Mr. Gordon's question, Mr. Fortier stated that he would be comfortable with 30% of the portfolio in real estate related loans. Mr. Neapole added that the real key was quality loans, without focussing unduly on any one sector.

It would be evident to the Board if no further disclosure were made that management's strategies were successful. All this is indicative or explanatory of the Board's extreme reliance on management.

It has been mentioned elsewhere that the OIGB took comfort from the more extensive audit carried out at the end of 1984 fiscal year. The same may be said of the directors. The following appears in the minutes for 4 December 1984:

> At the invitation of the Chairman, Mr. Detlefsen explained the reasons for the delay in finalizing the fiscal 1984 financial statements. He observed that the review process had been very intensive, that the auditors were satisfied with the quality of earnings, and that the outstanding issues had been adequately responded to by management. The management presentations made had left the auditors collectively with a great deal of confidence in what they saw to be a decidedly effective team. Mr. Scarth thanked Mr. Detlefsen for his comments and also for his long years of association with the bank.

At the Board meeting of 27 February 1985, the Dexleigh-Hees transaction was authorized and approved. There was also an up-date on the Cayman loan, and one director observed that this had been more than a loan workout: "It symbolized the turn-around that management had achieved for the bank", and, on behalf of the Board, this director thanked management for it.

The directors were also led to believe that the credit-granting process was rigorous. A presentation was made to the Board at a meeting held on 23 May 1984 by Guenette, who stated:

> An examination of the bank's total lending activities from May 1, 1982 through to and including April 30, 1984 has been conducted and has demonstrated ... that the credit approval process works eminently well. During the past 24 months, total loan authorizations including renewals of matured credits numbered 720 accounts for an aggregate principal balance of

> $643,930,000, thereby generating total fees of $4,710,200. A concurrent investigation was carried out so as to ascertain the present status of the above-noted credit volumes. Of the total of 720 accounts authorized over the past 24 months, a total of four accounts aggregating current outstanding balances at $3,979,000 have turned out to be, in some form or manner, problem accounts. ... It is interesting to note that all of the loans remain productive and no loss is anticipated on any of the four accounts. These four accounts represent all loans authorized during the period which have presented problems or are presently 30 days or more in arrears.

Willson made similar comments to the directors by way of a memorandum dated 14 May 1984. He attributed the bank's problems to the 1980-81 era, when all other lenders made similarly imprudent loans in Western Canada and were suffering similar portfolio problems. He maintained this position throughout his testimony before the Inquiry. It is obvious that if this was an accurate picture of the bank at that time, either there was little or no interest spread in these loans or the balance of the bank's loans were in far worse condition than the financial statements indicated.

The boarding procedure for loans also demonstrates the Board's exposure to the lending practices of the bank. The full Board approved only employee loans. Directors were provided with condensed reports of all loans over $3M for review. The Executive Committee reviewed all loans in excess of $7.5M, and approved loans over $10M and director-related loans. Less evidence was presented to the Commission about the operational structure of Northland. Management had little interest in the structure and perhaps it was less rigourously adhered to than in CCB. It is clear, however, that the directors were aware, in a broad fashion, of the workout strategies employed in the bank through the numerous reports of operations (which often focused on the success of the workout strategy) and the discussions of large workout situations. The Board also received an operations report at each meeting, which was a statistical analysis of the bank's operations. The content, as it appears from the Board minutes, changed from time to time.

What is absent from this review of the evidence is any serious consideration of the aforementioned loud protests. There seemed to be no desire to hear the bad news while good news was warmly received. Perhaps characteristic of the directors' reliance on management was Willson's move in May 1984 to change to a more summary reporting format of loans for Executive Committee review, and his expressed view that the directors should not interfere in lending decisions. There is little indication in the record that the Board ever disagreed with management after Prisco's departure. Numerous significant transactions were paraded past the Board or its Committees and were approved, including the Cayman workout and the income inclusion of interest on that loan over the auditors' protests, the restructured loan described above as CA12, and the Epicon, Dexleigh and Hees, and Rondix transactions. There is evidence, to be discussed shortly, that the directors failed to descend from the mountain of generality to the valley of the specific in relation to the important transactions in the bank.

The constant explanation threading its way through all the testimony relating to this bank, especially the evidence of Neapole, is that because of its lending policies and the management of its assets Northland had become an unusual or unique bank. It employed strategies which were well known to its own Board of Directors though perhaps not fully comprehended by the auditors and by the Inspector General. The record does indeed reveal that members of the Board made themselves familiar with Epicon and other concepts. One Board member, Johnstone, is an accountant and was Chairman of the Audit Committee. There was no question but that she was present at Board meetings where Neapole and others explained the workout strategies. Willson, as Chairman, of course was present throughout. Nonetheless it is clear that Willson, for one, was not aware of the reversal of the interest reversal, already discussed. Even if doubt is resolved in his favour and he was aware of the fact, his testimony reveals that he did not understand these transactions. The same applies with reference to all the directors who testified, including Willson, Skagen, and Johnstone, as regards the bank financing of all the "sales" made by Epicon. It is abundantly clear that the Board, or certainly its majority, did not have a grip on the survival tactics of the bank in its last three years, or their consequences. It is less clear, but still probable, that their knowledge of the lending policies in the first era of the bank was equally incomplete. It is trite to observe that if Willson, with his long experience as CEO and as Chairman of the Board, did not understand the true impact of Epicon, no one else on the Board was likely to have understood it either. Neapole observed in his testimony that it would be Utopian to expect that outside directors would understand Northland Bank's operations.

This was a Schedule A bank operating under the same *Bank Act* and supervised by the same OIGB as all the banks in the system, yet management convinced themselves of their uniqueness, and of their isolation from the rules and conventions of banking. The ends, certainly meritorious, were taken as justification for the means. All other elements in the system, starting with their own Board of Directors and including their external auditors and the regulators, were tolerated most of the time and disregarded some of the time. Management did furnish information to all these elements. It is difficult to determine whether the failure of the other units in the system to appreciate the workings of the management strategies was due to their inattention or incapacity, or was the result of a technically qualified bank management who were also very effective persuaders or salesmen. Probably some combination of each condition contributed to the result.

It is enlightening to note that one member of the Board, Mr. Thomas Assaly, a well-known businessman in Ottawa and a beneficial owner of 10 per cent of the outstanding stock of the bank, submitted a written list of comments and questions to the Board. He inquired, for example, as to why the bank classed a loan as productive when interest was in arrears more than 90 days. Management's reaction through Neapole can be summed up as a rejection of this kind of inquiry as evidencing a desire by a director to get into management instead of confining himself to broad questions of policy. Assaly's foray was substantially without success. This may have had a profound impact upon the other members of the Board who were not substantial shareholders and not as well versed in business in considering whether to take on management. Hence it would have appeared prudent for a director of lesser qualifications to remain silent. Siebens' departure may also have been contributory to the Board's declining position in the bank.

The role of the Audit Committee is more difficult to understand. The Committee, of course, had access to both the Chief Inspector and to the auditors. However, the Committee took the view that senior management was responsible for provisions, and that where the auditors supported the judgment of senior management that was the end of the matter, notwithstanding the Chief Inspector's reports. Johnstone said, in relation to the McLeod reports:

> We did indeed receive those and found them helpful, but the credit adjudication and the loss provisioning, as a result of that, were responsibilities of management and, through the management, the external auditors to inspect and decide whether the loan provisionings were in fact fair and reasonable as the management had decided.

That this conflict did not spark interest in the Board is all the more surprising when one realizes that on their surface, the Chief Inspector's reports made it evident that his calculations and records were fully borne out by management at the branch level, and were quite contrary to the constant flow of good news from senior management.

The evidence of Johnstone indicates that the Audit Committee, which met only twice in 1984, and not at all in 1985, should have met more frequently, and that in "hindsight", larger loan loss provisions should have been taken by management and required by the external auditors. Johnstone stated that McLeod should have taken his complaints regarding inadequate loss provisioning to the Audit Committee. This overlooks the fact that management was present at the Audit Committee meetings, something which Chairman Willson stated in retrospect should not have been allowed. There is no alternative but to conclude that the Audit Committee had ample opportunity to observe the levels of provisioning, to witness the challenge to senior management's position floating up all the way from branch management, and to take an active part at Board meetings in calling upon management to explain the level of provisioning and the practices in respect of income recognition. It is elemental that the Audit Committee, aware of the conflict between senior management and the Chief Inspector, should have put the same question to the external auditors. None of these actions were taken either at the Audit Committee or at the Board level, all to the great detriment eventually of the bank. The only explanation apparent on the record is the undue servility of the Board to management.

This quality in the Board is easily illustrated. In 1983, a recommendation by management to recognize a considerable amount of interest on a loan in the Cayman Islands was opposed by the auditors. The auditors were, however, overridden by the Audit Committee. The auditors recorded the Audit Committee's reasons for its decision as "it is imperative that Northland show as 'good a picture as can be justified' given the problem that small banks, including Northland, are having in obtaining funding to support loan portfolios". The matter was resolved at year end but it is illustrative of the willingness, if not eagerness, of the Board to follow along uncritically in the track of management.

Another example of the Board's relationship with management is found in the difficulties arising in connection with the nomination of external auditors. In January 1984, the Executive Committee of the Board accepted a recommendation from Neapole that Thorne Riddell be nominated as permanent lead auditor. That firm's familiarity with the bank held out the prospects of lower annual audit fees. The Board in turn accepted the recommendation of the Executive Committee to do so in February 1984. On 4 December 1984, however, the Board resolved to nominate Clarkson, Gordon and Deloitte, Haskins & Sells as auditors for 1985. The next day, Fortier, in a written memorandum to Neapole, said that to nominate Clarkson, Gordon as auditors of the bank would "put the bank at risk". On 17 December 1984, the Executive Committee, without reference to the full Board, resolved that in view of management's recommendation, the nomination of auditors by the Board would be changed to Thorne Riddell and Deloitte Haskins & Sells. This was an amendment of the Board resolution by the Executive Committee. The minutes of the Executive Committee indicate that

Chairman Willson had reported that the management recommendation for the change was "on the basis of new evidence" although the Chairman at the hearings could not recall what that new evidence was. The meeting was carried out by telephone conference, and there was no other business transacted at the meeting. There had been an episode, to be described in greater detail below, involving heated eleventh-hour discusions over differences between the auditors, principally Clarkson, Gordon, and management with respect to the accounting treatment of some fees and accrued interest which management wished to take into income as reported in the financial statements for fiscal year 1984. These differences were settled on 3 December. In light of all this, it is difficult to accept Neapole's explanation that he punished the lead auditor, cooled off and returned to the January 1984 plan, or to divorce his decision from Fortier's views. The matter is raised here to underline the evidence that the Board of Directors became a mere cipher in the hands of management, at least, where the question was said by management to be important.

Sometimes a board of directors renders itself ineffective in governing a company because its members become obligated to management of that company for preferences or perquisites granted to them. One such perquisite in connection with a bank is the ability to borrow money from it. Of the fourteen directors on the Board in the bank's final fiscal year, six had borrowed substantially from the bank, almost $7.5M in total. By the end of the bank's existence, its officers had borrowed $2.1M. Some of these borrowings occurred in the following fashion:

1. *22 May 1984*. On motion by Skagen, seconded by Neapole, Derrickson received a renewal of a $1M loan to assist the investment in the CA12 loan. Love, on the motion of Skagen, seconded by Assaly, received a loan for $968,750 bringing his total authorization to $1.168M.

2. *5 July 1984 meeting*. On motion by Assaly, seconded by Love, it was resolved (R.B. MacMillan dissenting) that interest-free loans be granted to Willson ($200,000), Neapole ($200,000), Fortier ($160,000), and to the bank's senior employees Scott ($135,000), Hayne ($125,000), Kellington ($100,000), Guenette ($100,000), and Naylor ($70,000). Walker and Wettstein of Epicon each received loans for $80,000 at prime rate.

3. *7 August 1984 meeting*. On motion by Love, seconded by Assaly, CA12 was further restructured, decreasing the required shareholders equity, and increasing the income debenture and

operating credit. The borrower was owned by Derrickson (then a director) and Dixon (who was Love's law partner).

4. *20 August 1984 meeting*. On motion by Barker, seconded by Love, Assaly's corporation received a loan of $7.5M to provide working capital. On motion by Assaly, seconded by Neapole, Love received a loan of $1.237M.

5. *26 February 1985 meeting*. On motion by Skagen, seconded by Beber, Love received a loan of $310,000. Other director-related credits were approved, including a loan of $1.75M to a director-related company, and a loan of $3M to another company, apparently related to the same director.

6. *22 August 1985 meeting*. The Rondix transaction was authorized. It was to be owned by Derrickson and Dixon. In the course of the meeting and prior to the vote, Derrickson resigned from the Board and withdrew. Most of the equity to be provided to Rondix by Derrickson and Dixon consisted of shares of the borrower in loan CA12.

These practices raise serious doubts as to the ultimate impartiality and the ability of the members of the Board to serve the shareholders and creditors as a neutral, effective element of corporate management of the bank. The directors' personal exposure on loans might have produced in some of the directors a condition of wilful blindness to the grave state of affairs in the bank from early 1984 onwards. It may be flaunting reality to expect a beneficiary of a lending or loan collecting policy to be a critic of those policies at a board meeting. This is a factor even where no default has occurred. The failure of the bank can certainly not be traced to these practices. They are, however, a factor which must be put into the scales and weighed along with all the others.

When the bank was put into curatorship on 1 September, the directors, including the Chairman, objected strongly. None of these objections appear to have been based upon any detailed knowledge of the state of affairs of the bank and, in particular, the state of the loans. The level of their informed understanding of the affairs of the bank in general, and the affairs of the bank on the issue of insolvency in particular, approximates their understanding in detail of the Rondix proposal.

This subject cannot be closed without observing that, as in the case of CCB's board or any other board, the Board of Northland Bank acted through a dynamic shifting majority in the actions it takes or fails to take. Some directors exercised their vote of disapproval of the bank's development by resignation. Another took steps to require from management more meaningful information. That attempt failed and may have discouraged others from taking similar steps. It has also been mentioned that inattention or incapacity to act may have been a cause for failure to appreciate the workings of the management strategies but that a contributing factor may have been the persuasiveness of management. While each director's circumstances would have to be assessed individually, it is the conclusion of the Commission that, overall, the Board showed undue servility to management in some of the steps it took as a group or failed to take. This conclusion leads the Commission to suggest changes for the future, as is seen in Chapter 6.

A discussion of the question of Board domination by management in this bank would be unfairly incomplete without a reference to the fact that Chairman Willson energetically advanced the view that board performance in every bank would be improved if the CEO were not also the Chairman of the Board. Kennett has long espoused a similar viewpoint. While Willson himself did not follow this practice, it is pointed out that he did not start out as CEO of the bank but moved to that post on the departure of two CEOs, and held the position during the searches for a replacement.

4. The Auditors

The expert evidence presented to the Inquiry on bank accounting and auditing practices is set out in Appendix F and reviewed briefly in Chapter 4. The following discussion proceeds against that same background, which shall not be repeated here. As was the case with the auditors of CCB, Northland's auditors, as individuals, had never undertaken a bank audit before their engagement with this bank. They communicated with other offices within their firm where bank audits were performed to obtain information and to build up an experience base. No issue has been raised about the proficiency with which the audit planning and procedures themselves were carried out.

The prime issue of importance is the auditors' treatment of the bank's assertions about security values and the earning status of the loan portfolio. In some cases the auditors were able to base their conclusions on appraisals of the loan security. Epicon is an illustration of this process. The auditors required appraisals of the properties transferred to Epicon. Those were provided by Messrs. Walker and Wettstein. The auditors relied "pretty heavily" on the expertise which Messrs. Walker and Wettstein were represented as possessing. No other appraisals were obtained. As mentioned in the description of Epicon elsewhere, properties were valued on an "investment value" or "added value" basis; these were "future value" concepts. Similarly, when these properties were sold by Epicon with bank financing, these concepts were used to justify the financing by the bank of the "purchaser" of the property as well as the financing by the bank of debt servicing, that is future interest payments by the borrower to the bank.

The fundamental issue is whether the auditors, possessed as they were of all the facts, should have relied on the Walker and Wettstein appraisals and the assurances of bank management. Walsten, the vehicle through which Walker and Wettstein participated in Epicon as already described, was paid a substantial net management fee by Epicon. In addition, Walker and Wettstein were each individually eligible to receive from Epicon such perquisites as were from time to time provided to senior officers of the bank. The bank provided Epicon with operating funds for the purpose of managing the properties. In essence, the bank paid the expenses of operating Epicon just as though it were a department of the bank. Bank nominees held three of the five director positions. Walker and Wettstein were associated with the bank in other workouts, and appeared at Board meetings on occasion to explain some workouts. Wettstein was the principal behind some of the SBEC loans discussed earlier. Finally, both Walker and Wettstein had personal loans from the bank in excess of $350,000 each. In short, Walker and Wettstein were both principals of the purchaser (Epicon) and closely associated with the bank which financed the entire cycle of the planned "disposition". The auditors contended that the Epicon principals would be inclined to depress the transfer price as far as possible in order to maximize their return in the upside gain, and that Walker and Wettstein, as principals of an equity contributor to Epicon (namely, Walsten), would tend to be independent. However, the equity contribution of Walsten was minuscule (20 per cent of $45.00). Walker and Wettstein were on both sides of the transaction in the sense of receiving compensation from the bank and participation in the transfers through the minority interest positions. The transaction either stands on its own or it falls, and internal appraisals can add nothing to the value of the bank. It should also be borne in mind as a fundamental fact of this arrangement that Epicon's and the bank's financial statements were consolidated so that an intercorporate transfer could not affect the original values at which these properties were carried by the bank. These "appraisals" were made much of by the auditors but, bearing in mind the fiduciary position of these entrepreneurs, their statement as to value, whether correct or not, should not have been relied upon by the auditors.

The evidence is that many of the properties were transferred out of Epicon to new borrowers with 100 per cent bank financing and more. In fact, the purchaser/borrower was a shell company with no other assets and no capital. No debt guarantees by the shareholders were provided to the bank. If the properties were so valuable, one would expect the bank to have insisted upon a contribution of equity by the borrower. When this question was raised with management, Fortier stated that in these workout situations, 100 per cent financing is inevitable, and that nobody in the real world of commerce would expect any other result. As discussed earlier, there is some truth in this but the explanation must be that in these transactions there is some uncertainty that, until the workout is successfully completed, the appraised value will materialize. Because of that serious risk the borrower is not willing to invest any equity in the project. The facts show that the valuations were too high and were in reality designed for the purposes of determining ultimate collectability of loans. The reviews carried out by the Royal Bank personnel under the direction of the curator, and the curator's opinion as to the value of the assets remaining in Epicon, support the conclusion that the properties were overvalued. Consequently the basic issue was whether a loss provision should not have been taken at once, whether or not the transfer prices had been reduced.

These longer-term values were not restricted to Epicon. The following, taken from OIGB files, is a general description of the audit approach on credit matters:

> ... The auditors stated that the bank does not lend money with the idea that it can get it back almost immediately. Rather most of its loans will take three or more years to come back. *In this regard Northland is probably different from other banks.* Recognizing this, the auditors do not take a forced liquidation approach to valuing security and loans. They listen to management's plans and expectations for each situation. Where liquidation was the approach assets were valued at current prices. *Where the bank looked upon the situation as a workout or longer term hold, future values were used.* (emphasis added).

The auditors testified that the "expectation of future value was certainly a very important ingredient" in valuing security.

Two questions arise from the foregoing. First, if Northland was "probably different" from other banks, would this be ascertainable from the financial statements? Second, did the Inspector General ever authorize the different accounting treatment and, if so, would such action affect the position of the auditors? Northland was engaged in a workout strategy. Mr. J.C. Smith of Clarkson, Gordon testified that the auditors certainly were made aware of the workout strategy during 1983. He said: "I guess no one was fooling themselves that the bank, however, was in great shape with respect to its loans." As late as April 1985, the auditors had indicated to bank management that they would continue to do what they had done in mid-1983 when the workout strategy of the bank was initially adopted; that is, they would monitor, observe and seek evidence on the progress that was being made on the workout strategies with respect to the loans. Given that the bank's general strategy continued to be its attempt to work the loans out, and that the bank felt progress was being made, the auditors simply continued within this framework. They did not set the clock running on even the largest loans where exposure to loss was considerable.

The auditors' general approach in light of the bank's workout strategy was well described in the following exchange with Detlefsen as to the reasons for the apparent drastic change in the state of the loan portfolio between fiscal year end 1984 and August 1985:

> A. ... the whole posture of support for the bank from the various sources, the regulator in terms of funding difficulties had changed, and the bank itself seemed to have taken steps that were getting away from long term resolution of the problem into short term solutions.
>
> Rondix, I do not think had happened at the time but that was a subsequent example. The time frame in August seemed to have compressed and [sic: but] the loan portfolio was dependent on something longer than a short term time frame. That was crucial to the bank's strategy.
>
> Q. Can I summarize that by saying the molten core of this bank, the loan portfolio, had not been itself organically changed but the view taken of it changed. ...
>
> A. I think essentially, that there must have also been changes in the loan portfolio. ...
>
> Q. There would be a little bit but it is hard to believe we have such a cataclysmic change as to say the bank cannot carry on. ... You are not suggesting that that kind of organic shift occurred in the makeup of the loans.
>
> A. No.

The auditors had accepted changes in accounting policy regarding the accrual of interest in 1983. Previously, the bank ceased accrual once interest was 90 days in arrears, except in rare instances where interest recovery was adjudged to be imminent. The bank amended its procedures to continue to accrue interest on loans where that interest was in arrears for more than 90 days and the bank had confidence in the management of the customer to "work out" the loan, where there was sufficient spread between the principal and interest, and the value of the security held, and where arrangements were made with the customer to make specific time payments, and those agreed payments were not in arrears. Apparently it was not a practice to require that all three conditions be met. Rather, the decision was a matter of judgment having regard to these three criteria. The second change to accounting policy was built on the first. It was the bank's opinion that its established accounting policies had to be "enhanced" to take into consideration the changed economic circumstances and the substantial amount of real estate being acquired under the bank's loan security. The bank decided to modify its policies in relation to foreclosed property. As the bank foreclosed on a particular property, its fair value would be determined and the bank would recognize in its financial statements as interest revenue the amount of accrued interest which had previously been unrecorded as a result of the troubled loan being considered "nonproductive". This would even include the recognition of interest which had been accrued but not recorded in periods prior to foreclosure. Essentially, the bank was reviewing its security at the date at which it decided to commence foreclosure proceedings, and recorded the value of the asset received on the basis of future considerations and potential.

In addition to the Epicon transfers, another similar accounting transaction within the bank came up for discussion in 1983. This was the recently restructured Cayman loan. The bank proposed to include approximately $600,000 of interest into income for the 1983 second quarter on the basis that the restructuring had resulted in an increase in the security value sufficient to support the inclusion of this interest in the bank's income, even though the loan had been and continued to be carried as nonproductive. The point of contention expressed by the auditors was the impropriety of bringing these amounts into income solely as a result of a restructuring transaction. Management decided to take the accrued interest (by definition, uncollected) into income because it was imperative that Northland show as good a picture as could be justified, and because bank management was satisfied that there was sufficient support for the principal and accrued interest in the value attributed to the security in the restructure program. This interest income apparently was never reversed and was treated in a manner similar to the Epicon transfers; that is, the property was foreclosed, revalued, restructured, and interest previously accrued was taken into revenue.

In the result it is clear that the accounting practices adopted in 1983 were less conservative than theretofore. The auditors appeared to recognize the dangers involved in this accounting change. One of them, McKay, in a memorandum dated 29 August 1983, wrote:

> Despite the acceptability of the accounting policy on a conceptual basis, we indicated the general concern of both Clarkson Gordon and Thorne Riddell as to the aggressive nature of income recognition to the maximum of the lesser of fair value of the property or the Bank's investment therein. Such concern was related to the stability of the Bank, especially in light of its problems in the latter part of 1982 and early fiscal 1983. Green and Naylor [both senior bank financial officers] seemed to share that concern.

That the auditors would allow such transactions, with full information, and an awareness of the bank's worsening condition, is very difficult to understand.

The Northland concept of added value is said not to be the same as CCB's baseline value. Whereas CCB premised future values on significant improvement in the economy, Northland management based its future values on the values that would be added by application of workout strategies and a general improvement in the economy as well. In view of the large number of workouts undertaken by the bank, and in view of the fact that the largest portion of the bank's problem loans were in real estate, it is self-evident that the economy would be required to improve to justify higher values on all these properties. It is simply impossible to believe that Walker and Wettstein, and SMART, could deliver the planned results in all cases. Fortier described Walker and Wettstein as "pretty smart guys". However, the strategy required them to perform major miracles in relation to all this real estate in the extremely depressed markets in Alberta and British Columbia, where most of the bank's loans were concentrated. McLeod testified before the Commission that one of the poor practices that existed within the bank was the entry into speculative real estate transactions based on future events. If such events did not occur, repayment of the loans would become extremely difficult. Neapole also testified that the success of the bank's strategy required a "reasonable economy" or a gradual improvement, and the Inspector General in his meeting with the auditors of 9 July 1985 regarded the recession as the rationale for the use of future values. There is, in result, no real difference between the valuation practices employed in CCB and Northland.

On the record here, the auditors, both Clarkson Gordon and Thorne Riddell, were familiar with the management policies with reference to workouts and were fully aware that the bank founded its program of income recognition and loan loss provisioning on the employment of predicted workout values and future values. There is no question of any interference with or impediment placed in the way of the auditors by management in the discharge of their duties and functions as auditors. There is also no suggestion that these auditors, who exceeded their time budgets in the 1983 and 1984 audits, had not exposed themselves adequately to the bank's records and staff.

Clarkson, Gordon were auditors of both banks. Both banks dealt in the future tense in connection with loan valuation because the present tense, by 1983 at least, represented insolvency. Terminological differences are unbecoming in a field as precise and demanding as accounting. No difference in substance can be perceived in the use of future values, even though the process is described in the two banks by different managerial vocabulary. Management of the Northland Bank talked about "added value" as the result of management of the unsatisfactory loans in workouts. CCB spoke of "baseline values" as being the value of the asset in question at some loosely defined future time, without any reduction in that value when it is brought back into current financial statements. Both concepts necessarily permit management, in conducting the valuation process, to take into account their expectations of economic conditions at some unascertained time in the future. Both processes offend the assertion in corporate financial statements that the balance sheet and the income statement are expressed as at the announced date, namely the last day of the last completed fiscal year. It is clear that the CCB management, by their workout strategy, did not intend to subtract value, and nothing was to be gained in maintaining value at what was assumed to be almost zero at the preworkout level. The only difference in practice that may be real rather than apparent between the two banks is that workouts were the rule in Northland Bank, whereas in CCB the level of workout loans as a percentage of the total loan portfolio might have been slightly lower. In both cases, valuation of an asset was simply a judgment passed by management at its convenience in order to postpone, avert, delay, or forever avoid the taking of a specific loss provision against a loan, or to enable the bank to continue to take into its income statement accrued or capitalized interest. To do otherwise would entail a drop in income and a drop in asset value at a time when the fate of the bank hung in the balance. The bank would be more able to attract replacement deposits. In both cases, the strategy was simply to buy time in the hope, and sometimes in the belief, that economic levels of business in Alberta and British Columbia would improve and return to something like the glory days of the late 1970s. Where the auditors went along with management's appraisal of value on this basis, they did so in violation of the edicts pronounced in the testimony before this Inquiry by Mr. Broadhurst and the other professional accountants whose evidence has already been described.

As has already been seen, the bank auditing experts all testified that valuations by management must be reviewed by the auditors by applying conservative accounting principles. Where the loan in question is in default, those judgments must be even more conservative. The auditors for Northland Bank admitted in their evidence that the bank was not conservative. Detlefsen, speaking for the auditors, said this:

> ... I recall [referring to the 4 December 1984 call to the OIGB] that we did advise the Inspector General on a scale of acceptability of 1 to 10, I think we used that analogy, that we rated the degree of conservatism in the loan

> portfolio at about 3. It was certainly within the acceptable range, but at the lower end of the scale, not conservative but within range of acceptability.

There is no reference in the documents to the auditors making a proposal with reference to loan loss provisions for 1983 or 1984. Nor is there a listing or aggregation of judgment differences. The furthest the auditors appear to have gone in scrutinizing these operational decisions made by management as they affected the accounting decisions to be reached in setting up financial statements, is found in the evidence, again of Detlefsen, where he stated:

> Q. So that you say it is an acceptable rule if there is a workout and you adjudge the workout to be reasonable and it will eventually be worked out, that is a basis for saying no provision is necessary?
>
> A. Yes.

What must be put against the auditors is that, notwithstanding the vast scale upon which loans were placed into workout, there was a very low level of specific provisions taken against loans in workout. Given the default condition of any loan going into workout, the severity of the Western Canadian recession, and the high proportion of the loan portfolio in workout modes, the failure to require adequate specific loss provisions is unwarranted. That failure results directly in an overstatement of assets in the balance sheet and of income in the statement of income. It was transparently an artificial state adopted as a survival expedient. The acceptance of these practices by the auditors was a failure on their part to comply with the principles of bank auditing as described to the Commission by several leaders in the profession.

Some explanation of the compliant nature of the auditors in Northland Bank may be found in the evidence of one of the auditors, Smith, who stated that since the financial statements are those of management and not of the auditors, it is management who must agree before any suggestions by the auditors can be taken into the financial statements. The process is, of course, quite the opposite. Unless the auditors can report to the shareholders that the financial statements proposed by management fairly present the financial position of the bank, the auditors may not approve those statements. It is a positive step which the auditors must take. They have no onus to demonstrate the negative.

There is another reason why it is difficult to understand why the auditors would be so susceptible to management proposals in this bank. Again, it is Detlefsen who stated:

> We went into a very large percentage of the total loan portfolio to determine on an item-by-item, loan-by-loan basis the extent of provisioning and the appropriateness of provisioning.

On the basis of this high proportion of loans examined, it is difficult to understand why the auditors would not have compiled a serious and long list of incidents where capitalization of interest had occurred, accrued interest had continued to be taken into earnings after the borrower went into receivership, and no specific provision had been taken on workout loans even though in some instances the workouts had worked through a series of borrowers without any recovery by the bank. Had the auditors taken a very small sample of the loan portfolio, one might expect there would be a wide margin of error or an inability of the auditors to gather the evidence necessary to put the case to management. Such is certainly not the case on the record here. Indeed the evidence is that the auditors in some cases exceeded their time budget for the audit by a considerable margin.

Perhaps this is all but an extended illustration of the failure of these auditors to apply the "stepping back" principle enunciated by Mr. Broadhurst. One does not need to go to the Detlefsen evidence quoted above to reach this conclusion. The auditors' approval of the Epicon transaction is perhaps a more dramatic instance where a stepping back would have enabled them to give much more weight to the end-of-the-road position where the sales by Epicon to third parties were wholly financed by the bank. The ever-increasing upward spiral of bank exposure still passed without any challenge from the auditors.

Further indication of a lack of stepping back is the auditors' failure to concern themselves with the quality of the lending practices. McKay stated:

> ... We did not think we were passing judgment on good or bad or indifferent lending practices. It was our view that during the scope of the audit we determined the Bank had established procedures by which they loaned money to borrowers. As long as those procedures were sufficient to obtain the proper approval ... we were satisfied that the bank had established procedures, internal controls, to ensure or to help ensure that good lending practices would follow.

A number of allegedly bad lending practices were reviewed with the auditors. In many cases, they responded that they had no basis to judge whether such practices were very common, not so common, or rare. It is difficult to understand how the auditors could perform a "stepping back" if they were not familiar with the frequency of certain practices within the bank. In this case, there is no documentary evidence to show that the auditors accumulated their judgment differences for those cases where the auditors acquiesced in managements' accounting treatment of a loan transaction. The minutes of Audit Committee meetings show that the auditors only occasionally expressed concern over judgment differences with management, and then ineffectively.

Reference should be made in more detail to the Mackenzie episode in December 1984 in connection with the completion of the year-end audit for fiscal 1984. In response to concerns voiced by the audit partners of Clarkson, Gordon, a member of that firm in the Toronto office, James Peers, had gone to Calgary to look at the audit evidence, and had raised serious queries about certain fee income and interest recognition in the financial statements proposed by management. These matters had been discussed by the Calgary partners in charge of the audit with Peers and on the unavailability of Peers, Mackenzie, a senior partner of Clarkson in Toronto, was chosen to take his place in these discussions. Before leaving for Calgary, Mackenzie and another partner, Mr. W. Farlinger, spoke to the Assistant Inspector General. He was advised that a bank (not named at the time) was capitalizing and taking into income interest accruing over periods of two years, on the basis that the real estate security held by the bank had been valued at a level which supported the loan principal plus accrued or capitalized interest. The auditors advised that they would not suggest loan loss provisions be made to reflect current market values of some of the properties. The Assistant Inspector General agreed with them that such an approach was reasonable. The auditors also expressed their hope to convince their client to take a more conservative approach to the recognition in the bank's income statement of interest income. The Assistant Inspector General responded, "we would support them in the event of a confrontation with the bank."

Mackenzie, armed with Peers' notes, went to Calgary and reviewed with the local auditors the loans in question, which raised the issue of about $2.5M proposed interest reversals and $2.4M of fee income deferrals. If these reversals and deferrals were put into effect, it would mean a loss of income sufficient to result in a nominal loss for the year. This matter arose in the dying days of the audit, presumably after management had concluded that the auditors would approve their statements which showed a reasonable income for the year. The ensuing debate with management was described as "vigorous and negative". In addition to being annoyed at the lateness in the day when this matter was raised, Neapole expressed his objections on the basis that since the 1984 results were better than those in 1983, the financial statements should reflect that improvement. Both sides to the debate undertook to discuss the matter with the Inspector General, and did so. Kennett left it to management and the auditors for resolution and showed unquestioning relief when this was achieved. In the end, a bargain was struck between management and the auditors which resulted in a reversal of $550,000 instead of about $5M as originally proposed. This left the bank's income statement in a profit position.

Was the Mackenzie visit a "stepping back" or of meaningful assistance to the local auditors in their "stepping back", if any? It is clear that Mackenzie was aware of the bank's problems in a broad sense. Following his visit at the bank, he wrote a memorandum which identified the substantial amount of interest on the books of the bank which had been accrued or capitalized and thereby taken into income. It identified uncollected interest overdue by more than 90 days, and the total principal amount of nonaccrual loans at year end. Mackenzie also recognized the question of future values, and addressed the issue of justification for no provisions where security was valued on that basis, and the unscheduled capitalization of interest in unsatisfactory loan situations. The difference in the impressions of the overall quality of the loan portfolio of the local auditors and Mackenzie sheds some light on the problem. The difficult loan situations in the bank were brought to Mackenzie's attention by the Calgary auditors. Mackenzie, in his record of the visit, described the two largest loan situations where interest overdue 90 days was accrued as the "least satisfactory of the large loans reviewed". On the other hand, McKay's record of the visit describes these same loans as regarded by Mr. H.G. LeBourveau of Clarkson, Gordon, and McKay as "being typical of the loans ... where interest income was being recognized. Also, such loans were regarded as ones where the Bank's posture may be regarded as aggressive relative to income recognition". Mackenzie testified that he did not get the impression that these two loans were typical loan situations in the bank and that his "concern level would heighten" if he knew there were a large number of such loans. Further, if the Calgary auditors were unable to quantify or even hazard a guess at the frequency of poor lending practices in the bank which would be required to perform a stepping back, then it was impossible for Mackenzie to do so. Because the evidence is that these auditors had not accumulated the data necessary to perform the stepping back process, Mackenzie's assistance was illusory.

In fairness to Mackenzie, it must also be said that his review of the loan portfolio was entirely limited to the three or four loan files concerned with the interest reversal and a handful of files relating to the fee income deferral. In all this he was largely in the hands of the local auditors. It was they who had examined the branch office files whereas Mackenzie, in the short time he was in Calgary, was limited to an examination, or to a discussion based upon the examination, of some Head Office files.

All of this appears to have led to the dropping by management of Clarkson, Gordon from the audit rotation for the year 1985 as earlier discussed. When these events are assessed with a similar incident in

1980, they greatly reinforce the conclusion that bank management effectively controlled the appointment of auditors according to their own interests and not necessarily those of the shareholders who appoint them.

This raises a more sinister problem with the present provision in the *Bank Act* providing for dual auditors rotating from a panel of three or more audit firms. Where, as is now the increasing practice, one audit firm is a permanent "lead auditor", the rotation effectively involves only the change every other year of the junior partner in the dual audit scheme. An auditor can be dropped by simply changing his position on the rotation, without the formalities applicable under s.240 of the *Bank Act* to situations where auditors have been dismissed by the stockholders. In the recommendations made later, remedies for this situation will be discussed. Interference by management in the process of the appointment by shareholders of auditors in the bank makes a farce out of the theory that the auditors are appointed by and for the benefit of the shareholders. As a minimum this type of action by management requires some explanation to the shareholders on the appointment of auditors, and under the *Bank Act*, to the regulator as well.

The dealings with the Inspector General in the course of this episode are perhaps equally disturbing. As mentioned earlier, the Assistant Inspector General initially promised support for the auditors in the event of a confrontation. It was the evidence of Mackenzie that he would have preferred support from the OIGB on these reversals, and he stated that the result at the end of the day left him rather uncomfortable. However, when the auditors called Kennett and received no support from him in their stand, they, in the words of the testimony, "left the field" in short order. All of this may have left the Inspector General with a misplaced sense of assurance. Here the experienced bank auditor from Clarkson Gordon's head office had gone to Calgary, met with management and put the seal of approval on the financial statements for the year 1984, a crucial year in the history of the bank. There is nothing to indicate any penetrating inquiry by the OIGB to determine the extent of the differences between management and the auditors. There is not even much evidence of curiosity to determine how such a material issue (profit or loss for the year) could arise so late and be settled so quickly. More serious is the question why, when the Inspector General avowedly relies upon the external auditor to inspect the bank's loan portfolio and the appropriateness of the accounting treatment of the bank's transactions reflected in its financial statements, he did not support the auditor in this issue, or at least have someone in attendance to observe its resolution. These events did not appear to shake the OIGB's complete reliance on the auditor's certification.

If we "stand back", in the words of Mr. Broadhurst, it is evident that something must be wrong with a system which can produce financial statements for a bank, approved as being fair by external auditors and showing an improvement in the condition of that bank, when the true situation revealed by a close examination by neutral examiners of the loan portfolio is quite the opposite. In the case of CCB, the trend in financial statements was down through the last critical years of the bank's history. In Northland Bank, the last financial statements in fact showed some improvement. The underlying facts belied this representation. This result must have followed the sad sequence of events commencing with the almost automatic decisions taken by management to place bad loans into workouts and to accord to the transaction an accounting treatment favourable to the bank's struggling position, and continuing with the auditors' acceptance of the accounting treatment proposed because they could not challenge the underlying operational decisions of the bank's management. All this is in contravention of the principle enunciated by Mr. A.J. Dilworth, representing the CICA, who said that where there is an apparent threat to the existence of the bank as a going concern by reason of an extremely large proportion of its loan assets being in arrears in one way or another, the auditors should use even more conservative valuation practices. That test clearly was not met here.

Few illustrations need be advanced to demonstrate this lack of conservatism by the auditors in reviewing actions taken by management in working out an unsatisfactory loan. Two will be briefly outlined. The first loan originated in 1980 and fell into default shortly thereafter. Restructuring and juggling persisted through the next two years. This took it into the era of Prisco who, on reviewing the matter, referred to the principal of the borrower company as a "crumb-bum". By the end of 1982, the loan had been placed on the NPL list and $150,000 in recognized interest had been reversed. $2.5M in principal, plus a considerable amount of interest due, remained outstanding. By the time the bank went under the control of the curator, it was determined that the bank had been losing about $400,000 per year on this loan during a four-year period, and even though a receiver and manager had been appointed in 1983, and a bank officer had calculated a liquidation shortfall on the security of $1.15M in 1982, interest had consistently been accrued or capitalized and recognized as income since 1983, and no specific provision had been taken. The bank's internal inspector awarded the loan his lowest rating class. The bank had never realized on the security held, and its exposure continued to climb throughout. All this was justified, according to management, by an enhancement from time to time of the underlying security value based on appraisals, rejected offers, and other transactions, and restructuring proposals which never closed. It was not until July 1985 that the auditors and management had judgment differences in respect of the accounting treatment for this loan.

The second loan is an example of the noncash loans set up on workouts where funds were advanced for interest servicing, justified by an optimistic view of the workout schemes. This loan was secured by a piece of property in downtown Saskatoon. The property was sold by Epicon for $2.1M, but the bank provided $3M of financing, there being an additional $900,000 to enable the borrower, among other things, to pay future accruing interest. Walker and Wettstein projected that should the proposed development go ahead, the value of the property would be just slightly in excess of $2M. The borrower was a new company, and the principal behind the borrower was a well-connected local entrepreneur. He is described in bank documents as "truly a friend of the bank, sitting on the Saskatoon Regional Advisory Council where he plays a most active role in the bank and having recently acquired 50,000 shares of the bank". The principal was also said to be well connected in Federal Government circles and chaired a board in charge of realty owned by the Government. Thus, the bank was certain that with his Government connections, the principal would be able to complete his development plans for the property in a short period of time. Guenette testified that the purchaser demonstrated to the bank that within two or three years, he would have successfully negotiated "very material leases". There was an appraisal indicating that the value of the property was $1.56M, leaving a shortfall to the bank of $1.47M. The appraisal was considered to be very conservative due to the prime location of the property. Since negotiations for an office complex were "in advanced stages", the auditors decided that a more optimistic security evaluation was justifiable, and deducting the term deposit held to meet interest payments, there was a shortfall of $229,000. The effect on current year pretax income was approximately $46,000, which was not considered material. There did not appear to the auditors to be sufficient ground to record a provision.

Other loan reviewers were less optimistic. The Royal Bank team identified offers received for the property of $1.75M (verbal), $1.5M (written) and $700,000 (verbal). They valued the asset at $1.3M, established a loan value of $975,000, added in the term deposit, and classified $1.7M of the loan as bad, and $400,000 as doubtful. McLeod reviewed the account in June 1985. He stated that demand for such property is not good, and described the deal as "a workout situation predicated on a return to more buoyant pricing". Management, in their response to the curator's assessment, remarked that $1.7M of the loan was to be transferred to Rondix; once more through the washing machine.

There were many other such loans. All of them fall into perhaps an imprecise description in the accounting world, but a telling one in the real world, that is, a noncash loan. Such loans produced no cash income throughout all these years and yet sustained the reported income of the bank. The carried value in the balance sheet. It may not be easily depicted in accounting terms, but the picture of noncash loans on the scale found in the Northland loan portfolio is a bleak one indeed, which, by some adjustment to accounting rules, must be reflected in the financial statements of any bank which may subsequently fall into the condition of Northland Bank. To permit otherwise is to allow two banks to exist in one; one as depicted in the financial statements, and the other as it exists in market reality.

The auditors during these years had considerable contact with both the OIGB and the Audit Committee of Northland. This has been detailed elsewhere. In the course of these contacts with the Audit Committee, for example, in 1983 and again in 1984, discussions were held in connection with recognition of interest income and loan loss provisions. In none of the year end discussions did the auditors inform the Audit Committee of any disagreement with the management approach to the treatment of loans and to the preparation of financial statements for the bank. There was one disagreement in the course of mid-year discussions (the income inclusion on the Caymans loan), but this only "culminated in a review of accounting policies", and by year end was considered acceptable. This acquiescence, if not outright approval by the external auditors, robbed the Audit Committee of any zest it might have felt for a challenge to management on major loans known to the Audit Committee or on the general issue of income treatment by bank management. Indeed, the Mackenzie episode, and perhaps more particularly the Inspector General's acquiescence in its outcome, again must have had a similar impact on the Audit Committee's curiosity or perhaps its aggressiveness in its dealings with management on the treatment of the loan portfolio in the financial statements of the bank.

The auditors take more specific reassurance from some of the comments by members of the OIGB, with reference to an understanding that a reasonable approach must be taken towards current market values and the accounting treatment to be accorded to workout loans. No one lifted the discussion to the level of making the Inspector General a partner with management in these adventures, but the testimony of the auditors comes close. The high water mark was the failure by the Inspector General to join in support of Mackenzie when he was seeking that support in a serious debate with management on a quantity of income recognition which was material to the earnings of this small bank. The Inspector General's neutrality and stand-off position again must have been taken by the Audit Committee and by all spectators to the event that management was, in these difficult times in the bank, on a track which was known to and approved by the Inspector General.

The auditors' position in final form was simply that they had but one drastic remedy at hand, namely the withholding of approval of the proposed financial statements. This, of course, would be tantamount to a closing of the bank by the auditors. They professed no such power, and indeed, claimed that they were not in possession of evidence or information sufficiently drastic in nature to warrant such a drastic remedy. All of that, of course, overlooks their only duty, namely the examination of the proposed financial statements to determine whether they are, in accordance with applicable accounting principles, a fair representation of the financial position and results of operations of the bank. Whatever the consequences may be, this is the auditor's solemn duty. The difficulty ~~of~~ their position is recognized by all but that is small comfort to an auditor who, for an appropriate consideration, is called upon to exercise this grave and lonely duty. The auditors, on the documentary and testimonial evidence before the Commission, clearly failed to apply in their judgment on the fairness of these financial statements as prepared by management in the year 1984, and probably as well in the year 1983, those accounting and auditing principles and practices pertaining to the audit of banks. The Northland Bank statements did not, on the basis of the information revealed in this record, fairly present the financial position of the bank at the 1984 fiscal year end, and probably at the 1983 fiscal year end as well. Accordingly, the auditors should not have issued their certificate of approval of these statements for 1984, and probably should not have done so for 1983. This is not an assessment of circumstances exercised in hindsight and based upon loan reviews after the appointment of the curator, but rather a judgment which must necessarily be passed on the basis of the record as revealed and known to the auditors by 31 October 1984.

This forum is, of course, not directly concerned with the resolution of the issue as to whether the auditors, or any of them, were in breach of a duty owed to anybody with respect to the events which have been investigated here. The sole function of this Commission of Inquiry is to determine the causes of failure of the Northland Bank and to make recommendations with reference to any applicable laws or regulations or practices which might improve the situation in the years ahead. Therefore, this Commission expressly refrains from making any finding as to the violation of duty, if any, owed by the auditors to persons who have participated in these hearings or to any other persons. It is sufficient in the discharge of duty of this Commission to conclude, and on the record here, such conclusion is unavoidable, that had these auditors applied the principles of bank auditing as enunciated in the record before the Commission, the financial statements for the year 1984, and probably 1983 as well, would not have been approved by the auditors. The Northland Bank would have been insolvent and identified publicly as such prior to 1 September 1985. The financial statements of fiscal year 1984, if prepared in accordance with the policies of accounting and bank auditing principles to which reference has already been made, would have disclosed that the bank was insolvent at that time in the sense that it would have had a negative net worth. No precise conclusion on the record before the Commission can be made with reference to fiscal year endings prior thereto but it is reasonable to conclude that, in all probability, the same situation would have been revealed at fiscal year end 1983.

All this is said with reference to the information compiled publicly by the Commission. It may be that another forum, not as free as a Commission of Inquiry to receive information from all sources, would be faced with a different record. The above conclusions are reached entirely on the basis of the record here without any attempt to ascertain what the result might be if other rules or processes applied.

5. The Inspector General

It should be determined, if possible, whether the Inspector General had actual knowledge of the situation in Northland which, correctly construed, would have led to a finding of insolvency in the bank, probably at year end 1984, but most certainly well ahead of 1 September 1985. There may well be a different situation revealed. While short of actual knowledge of the entire program initiated by management and approved by external auditors, the Inspector General may have been necessarily aware, from the information laid before him, of the ramifications of these actions and the consequences they posed for depositors and investors in Northland. In short, the innumerable contacts heretofore examined between the OIGB and management, directors and auditors may disclose a growing awareness in the Inspector General, over the years in which the bank operated, of the true inherent financial condition of the bank and of some of management's practices which contributed to that condition.

In the early years of the existence of this small bank the OIGB appeared eager to treat it on the same basis as the major banks, to accept management as being adequate to the task and to assess the results as being conventional and consistent with the balance of the banking industry. What deficiencies were noted were not followed up effectively by the Inspector General. This is the appearance of the state of supervision from the evidence, but without a full-scale examination of the inspection activities of the Inspector General in the other banks during this period, one cannot say this is more than "an appearance".

As has been seen, the Inspector General, early in the years of serious difficulty of the Northland Bank, commencing in 1982-83, became aware of the survival tactics adopted by management, including primarily the invocation of the practice of establishing security values using undiscounted future values for that purpose, all to the end of gaining some time for what was regarded as the inevitable return of good economic conditions to Alberta and British Columbia, which would restore value to the bank's loans then classed as unsatisfactory in one way or another. The process may not have been fully understood by the Inspector General, but there was an awareness of the gap which had arisen between actual present market value of assets and the value perceived by the bank by looking ahead to some unascertained time in the future.

None of the contacts by the OIGB with the bank assumed the proportions of the later hands-on examination of loans in the bank's portfolio. The awareness of the OIGB was limited to that which could be learned from discussions with the external auditors and management, and from the annual inspection which did not descend to the level of loan file examination. Consistent with the pattern into which the OIGB lapsed in its supervision of this bank, the inspectors relied heavily on management's explanation of the workout programs in the bank and even more heavily on the auditor's acceptance of the accounting treatment of the practices which flowed from the various workout strategies.

After the beginning of the CCB bailout process and the revelations connected therewith, the Inspector General gradually moved to a fuller understanding of the details surrounding the loans comprising the bank's loan portfolio. With that awareness came an unease resulting from the knowledge that there was a considerable gap between values assigned to bank assets under workout and the then current realizable market value.

In the final analysis, the OIGB adopted the position that the missing values in the loan portfolio were occasioned by the effect of the serious and prolonged recession in Western Canada and that the regulatory system could advance no magic solutions. Only an economic upturn could save the bank. The OIGB appears to have accepted the fact that the missing values were not detected because of the traditional reliance on the auditors' approval of the financial statements, and because the auditors failed to properly perform their functions when approving the statements of this bank in its later years.

Over all these considerations hangs a failure by the Inspector General from the earliest days of these two banks to appreciate that these small regional banks, however designed and launched, presented a different regulatory problem and challenge than did the existing Schedule A banks. Nowhere did the OIGB reveal an intention to establish criteria for supervision designed precisely for the needs of this small, regional, Western Canada oriented bank, engaged heavily as it was almost from the outset in investment in local industry which was predominantly real estate and energy of one kind or another. For example, the Inspector General in his testimony said:

> I recall in the early days being concerned because the bank did not seem to be developing in the way that was suggested by the entrepreneurs who had established the bank when they were before Parliament to receive their charter. ... On the other hand, ... we were not particularly concerned about the lending practices of the bank. ... Our impression was that those lending practices were reasonably conservative. ... I must say we were, perhaps, ... overly impressed by the management of this bank. On the other hand, they were experienced in some degree and I felt that their careful growth represented a realistic appraisal of their own capabilities in the circumstances.

On the precise issue of the extent of the Inspector General's familiarity with the basic strategy adopted by the bank in order to gain time sufficient to restore value to the loan portfolio and confidence in the market, the Inspector General testified in part as follows:

> I cannot recall exactly when the strategy was set out before my office. I suspect it developed a bit piecemeal through time, but certainly part of the strategy was to keep the bank capitalized. ...
>
> Another strategy was to grow out of the problems. The book is full of evidence about the growth strategy and the concerns we had about the growth strategy, but the growth strategy, I had hoped, insofar as it was being pursued and we were not recommending it, was to lead to a greater diversification of loans and was to lead to a strengthening of the credit portfolio . ...

Mr. Kennett then acknowledged an awareness of the Epicon transaction and described it as "bundling the real estate loans and finding the best possible management the bank could for those loans to try to retain or restore values and eventually to market them and to keep the bank whole by that process". He concluded that, "... the basic strategy seemed sound and we welcomed the concept ... of finding the best possible management for the package of nonperforming or difficult real estate loans". He then stated, in response to a description of the bank's treatment of loan loss provisioning and income recognition:

> That was not explained as clearly as you have set it out to us; at least I do not recall that. ... But that was an area that troubled us and indeed it led to a considerable discussion in relation to the establishment of Epicon to focus it on a particular instance.

The Assistant Inspector General, Mr. Macpherson, joined the discussion in the Commission and added the following:

> First, we recognized the restructuring approach that the bank was taking to try to work out of its troubled loan situations, that we knew that inherent in that was a certain forward-looking approach to establishing values of the properties that were concerned, and also that in the course of that there was a degree of interest capitalization or income recognition, but that we also believed and we understood that they believed that there was a finite limit to that. You had to stop doing that sooner or later, so there was a timeframe around that.

These and other comments in the evidence indicated that the OIGB, rightly or wrongly, understood throughout that the workout strategy would involve a valuation basis of assets concerned which reflected the process of workout but which was subject to an overall time limit. The evidence is very imprecise as to what that time limit was or when that understanding was attained by the OIGB. The Inspector General and his staff recognized that all of these workout strategy ramifications were unfolding at the same time as the bank was endeavouring to shift its reliance from wholesale funding to retail funding. This raised separate concerns in the Inspector General's office: "We roughly calculated that the cost of the new money in that form was at or perhaps even above the bank's prime rate so clearly there was no room for any material spread". At the same time, the Inspector General was made aware that the bank was endeavouring to generate significant fees from merchant banking without any increase in the bank's balance sheet. Macpherson then concluded, on this aspect of his testimony:

> In our view, in May, [1985] all of those three key factors had to produce results, satisfactory results, within a very short time. I believe that we made it as clear as we could that we felt that time was indeed running out, that there was not that much more ability in the asset portfolio to sustain income recognition, that we queried whether the bank indeed would be able to continue to attract and hold retail deposits at the prices they were having to pay, and we seriously doubted the ability of the bank to generate fee income without adding to the asset side of the balance sheet. ...

All these latter discussions were held in the month of May which was very late in the day, of course, for Northland, and for a recognition by the regulators of the state of affairs in that bank. Macpherson continued, in response to this question from Commission counsel:

> Q. I gather that in May of '85, you were not having the strategy explained to you for the first time; you were aware of the strategy, but you were telling the bank that time was running out?
>
> A. Yes, sir.

Mr. Macpherson later testified, in answer to a question as to when the Inspector General first became aware of this program in detail: "I think back in 1983 we were prepared to see and live with the bank in an attempt to get through this period". He made it clear, however, that he did not believe the OIGB ever precisely put the bank on notice that the OIGB reserved the right to say that the time was up for all these survival tactics, "... prior to perhaps ... May of '85".

> Q. They complain that they were misled that you went along with this strategy and then suddenly blew the whistle.
>
> A. That may be their view, but I think again as we were going through the various inspection reports, we continued to see expressions of our concern regarding growth, regarding provision policy, regarding reliance on noninterest income and the other different difficulties that we regularly brought to the attention of the senior management.

This slow realization of the true import of the workout strategies and the need for some curbing activity by the Inspector General can be seen in the succession of memoranda prepared in the OIGB, including one in April 1984 which stated in part: "It is obvious that the bank desperately needs earnings and any accounting treatment which can show these will be employed". It should have been no surprise for the OIGB, therefore, to discover the reversal of interest reversal episode discussed earlier.

There are other instances of inaction in relation to disturbing information, or failure to acquire information. For example, the OIGB recorded that Prisco advised them in May 1981 that "loan quality remains high". This statement is not consistent with Prisco's testimony about the bank's condition. It may be that this statement is the conclusion of the OIGB officer drawn from the discussion of one particular loan, and Prisco's assessment of the condition of the loan portfolio was not challenged by OIGB counsel in cross-examination. In any event, by 1982, after the recession set in, the OIGB annual inspection revealed the auditors' observations that there had been some weakening of loans, and Prisco's view that the lending process had to be tightened. In an October 1982 visit, Grant questioned the bank's income recognition practices and its failure to adjust collateral value to reflect the deterioration in the economy. While Macpherson had visited the bank on 1 October 1982 and learned of a senior bank officer's "thorough review" of the loan portfolio and the bank's satisfaction that "the portfolio contains no more surprises", he seems to have expressed no strong reaction to Grant's findings which came but 3 weeks later. He simply wrote on Grant's report "As for [sic] CCB, extent of income recognition is dubious".

The OIGB was also aware of the future value philosophy employed in the Epicon transactions. While the Inspector General testified that he thought the sales out of Epicon were normal commercial sales which would lend credence to those values, OIGB files show that it was reported in early 1984 that there had been a large swap of properties with a trust company which involved a large amount of bank financing. In late 1984, the OIGB learned that about 25 per cent of the Epicon dispositions had been by way of swap and that "outright sales accounted for about a 25 per cent reduction in the portfolio". As discussed earlier, the true facts are that the transfers out of Epicon, whether by trade or sale, were predominantly financed by the bank. In any case, the material on the OIGB files, while not fully reflective of the true position, should have been sufficient to cause the OIGB to question much more closely the operations of Epicon.

It is notable that the OIGB initially expressed skepticism about the bank's workout and dilution strategy. A memorandum of October 1983 states in part:

> Neither of the above approaches is without difficulty. The restructuring of nonearning assets may be more protracted than foreseen or involve the need for greater provisions than already made. Careful judgment is required in the decision as to when a loan should be restored to the current category with the possible "recovery" of substantial interest not previously taken into income. If the loan should subsequently fall back into difficulties and become either nonearning or require a provision management could face criticism.
>
> The dilution through rapid (approximately 40%) growth approach to the Bank's problems requires that it be significantly more successful in its credit judgments than it has been in the past. It must also be recognized that the Bank's previous growth was achieved in a period of rapid lending growth by all banks particularly in the Alberta and British Columbia markets. The general impression gained on our recent Western trip was that the return of this epoch is not imminent and the the Alberta economy in particular will continued to be slow to recover.

Many other similar concerns punctuate the record. It is clear that the OIGB had been concerned about loan loss provisioning and income treatment since 1982. It knew the bank aggressively pursued workouts and was desperate for earnings. It knew that management justification for income treatment was based on intangible factors such as "changes in the near future". It knew the bank tended to grant large loans. What it did not seem to know was the impact of all of this in hard figures. It never attempted, until the summer of 1985, to implement any sort of strategy to particularize its concerns. There was a lack of follow up, as evidenced by the lack of any coherent stream of data on particular subjects from time to time. This was a small and vulnerable bank. When it undertook the significant workout strategy it surely would have been prudent for the regulator to require detailed, timely, and customized information to assess the strategy rather than "piece-meal" information. This is particularly important where as here the bank was so heavily dependent on a very large number of workouts; indeed a significant fraction of its loans was in this state. Similarly, the OIGB somehow failed to discover anything in its inspection visits about McLeod's reports which clearly showed the portfolio's condition to be worsening. The evidence of the Inspector General, however, was that through all these years up to May 1985, the OIGB did not become aware of the condition of the loan portfolio. He acknowledged that the evidence must have been rolling into the OIGB from 1982 onwards as the recession deepened, and that problems were piling up in the bank loans, but:

> We were not in a position to measure that ... but we could feel it in certain specific instances that came to our attention. ... [F]inally, by the time we got into 1985 we began to get information with greater precision. We saw the bank itself struggling more visibly to sustain itself. The jig was up. We recognized finally the extent of the damage of the portfolio. ...

All of this appears to result in an indirect acknowledgement of the effectiveness of some kind of hands-on inspection or check-up at least once in a while and in some banks. On 25 May 1984, the Inspector General wrote to the Minister of Finance stating: "I inspected the Northland Bank last week and am satisfied that the Bank is in a sound condition". When questioned about this report, the Inspector General's reply was:

> I suspect, and I can only suspect, Mr. Sopinka, but if we had sent in a team of experienced credit officers from the bank, from banks, that we would have got a much more bearish report than I would have reason to believe that at that time. That is hypothetical.

In contrast, the Inspector General had, in fact, been relying extensively, if not completely, upon the auditors' approval of the bank's financial statements in the years 1983 and 1984. He said we "took comfort from what the auditors said" and he "was certainly guided by the professional accountants in this matter". The OIGB brief to the Inquiry ascribed the failure of the tripartite system of inspection and regulation to the failure by the auditors to perform their function properly. The brief refers often to instances where the OIGB sought assurances from the auditors and the general position appears to be as follows:

> Until the summer of '85, OIGB had accepted the external auditors' certificate as an assurance that the statement of assets in the Bank's balance sheet was realistic. Further and specific assurances were sought from them during the inspection visits. ... However, increasing skepticism led Macpherson in June '85 to challenge the external auditors' acceptance of the financial statements of '84. ... Even at that late date, Clarkson Gordon had no qualification to make.
>
> As is now known ... OIGB's skepticism was not unfounded.

The debate reduced itself to a contest between two corners of the triangle as to whether the reliance was misplaced or was ever revealed to those upon whom reliance was placed, namely the auditors. The OIGB was not always consistent in taking this position. As we have already seen, the Inspector General did not support Mackenzie in his confrontation with management on the settlement of the 1984 statements. He did not question the validity of the resulting statements even though he was fully aware of a serious difference between management and the auditors as to the fairness of the financial statements as prepared by management. How then could the Inspector General thereafter blindly rely on these statements for the answers to all his concerns about the bank?

The same inconsistency arose in the dealings between the Inspector General and Wood Gundy, the underwriters, concerning the condition of the bank prior to the last public offering of securities by the bank. The Inspector General did not refer any of the questions put by the underwriter relating to the financial condition of the bank to the auditors but purported to provide the requested information himself or through his staff. The answers provided related both to detailed questions and to general conclusions. No mention was made according to the evidence taken by the Inquiry of any reference to or reliance upon the auditors.

Like the auditors, the Inspector General too fell into the habit of accepting management's decisions and expectations. The same situation developed in CCB, as has already been seen. For example, the Inspector General had slipped into acceptance of management's open-ended workout practices (as had the auditors), perhaps recognizing inwardly that a time limit was implied or inferred or must necessarily exist, but never overtly advising management that such was the thinking of the Inspector General. Clearly the workout policy was approved at a time when there seemed to be no reasonable alternative for a bank facing the depths of a lengthy recession, and with no other course of action available than to accept the inevitable and surrender to liquidation. The management plan, put at its highest, was to work out the losses, stay with the borrower, hope for a return of prosperity and a turnaround in cyclical industries (mainly real estate and energy loans) and generally to reflect the workout strategy in the accounting of the bank in the way most likely to encourage confidence in that bank, but all the while consistent with the applicable accounting principles. However, the Inspector General never does answer the precise question why this workout strategy program was approved by him without telling the bank at that time, or reasonably soon thereafter, that the workout program as a means of forestalling reduction in loans values in financial statements and protection of income in those statements must have a term on its life. The explanation given was as follows:

> But an implication to that was that there was some postponement in the recognition of market values and in the provisioning process. That postponement could only occur, in my view, over a relatively short period of time. When two or three years later we were still exercising that same kind of strategy largely in relation to those same kinds of assets and provisions were not being taken, that situation had to change. As I said before, that gap between market values and intrinsic values or however you want to express it had to narrow, and it was not narrowing. The market was not coming up rapidly to meet those anticipated values and something had to be done.

In hindsight it is easy to see the error. It is not so easy to see what the regulator might otherwise have done, dependent as he was upon the tripartite system of regulation, starting with management, and passing on to the external auditors' approval. Furthermore, it is true that the workout plan was at least partly sound. Faced with a deep recession across its whole operating area (except for a new off-shoot in Ontario), what could Northland have done but undertake workouts of bad loans. This plan lost its prudential base, however, when it was applied across a high proportion of the bank's loans and, frequently, for the ulterior purpose of protecting the income and asset statements, not primarily to achieve significant recovery from effort and money invested in bad loans.

Events combined to force the imposition of a finite time limit on the workout program. That limit in reality was, of course, the necessity to recognize insolvency when it was written in such large print. The "wink and nod" system of regulation was bent around to a wink and nod system about solvency itself. When indications of insolvency became too intense and too distinct for anyone to ignore, the regulators, the Bank of Canada, and the Department of Finance came at about the same time to a final, last-ditch, no-alternative realization that the end of the road had been reached. At that time, of course, everyone concerned cast their eyes backwards and began to wonder why this act was allowed to play itself out to this end over such a long period of time and to such damage to many of the persons involved.

The workout program did not bring the bank down. The workout program simply delayed the collapse. The culpability of those who permitted the program, starting with management, is not an issue before this Commission. We are simply determining conditions contributing to failure and the workout program contributed only to the postponement of the inevitable. All this is very frankly discussed by Mr. Kennett in the following exchange:

> Q. ... My second question is not wholly unrelated, and that is, given the state of affairs that we have just now discussed, what regulatory system could have saved this bank starting in 1982, if any?
>
> A. As you have put the question, none, in my view. The die was cast. With the deep and prolonged recession, the bank was caught in its asset structure and concentrations, and nothing but significant recovery in the economy could have saved the bank.
>
> That could have saved it had we had what I might characterize as a normal business cycle, it would have come out of it within time frames that would have been acceptable, but we were not in a normal business cycle in this circumstance.
>
> We had got into the problem through a period of prolonged prosperity with mounting inflation and then with a considerable amount of speculation in the real estate market in this province [Alberta] followed by a very severe recession that turned into a very prolonged recession, and indeed, with what is happening now to oil prices may be still more prolonged. I think the answer is that no regulatory supervisory system beginning in '82 could have saved this bank.
>
> Q. My last question is: We have heard a great deal with a wide variety of adjectives about the strategies and plans, programs, devices, procedures, one thing or another, adopted by this bank and CCB. Did the regulators in assessing the work of those plans and programs and their acceptability in the overall banking system in our Canadian community, was the regulator influenced by the fact that if the Alberta economy had come back in '83, '84, that the bank probably would have staggered back? Was that an influence which you took into account in permitting or not prohibiting some of these measures?
>
> A. It was certainly an attitude, and I will speak for myself, sir, I think personally if I may. That was an attitude that influenced us in these determinations.

Clearly, two events coincided. The first was the fact that Northland simply ran out of money. The bank was putting into the cash box IOUs which could not be collected while simultaneously taking out of the cash box what little cash remained to pay the operations costs of the bank. Eventually the paper well ran dry. This was about the time of management's confessions to the Inspector General on 20 July 1985. A similar sequence of events had driven CCB to the same confessional on 14 March. The second event was the implementation by the Inspector General of measures to obtain a first-hand knowledge of the state of the Northland's loan portfolio. The bank's economic paralysis was then seen in stark reality and events in the OIGB marched rapidly from that time onwards to the final determination and appointment of the curator on 1 September 1985.

There is virtually nothing in the evidence, documentary and testimonial, before this Inquiry to indicate that the decision made in late August for the appointment of the curator was erroneous or could thereafter have been reversed. That it should have been made sooner is now obvious, although it might not have been to those embroiled in the events of the summer of 1985. The unwillingness of the management of the bank to see their bank die was natural, and their zeal and efforts to the very last to keep it going cannot, by themselves, be criticized. As observed earlier, where those efforts and that zeal carried the bank beyond the rim of accounting and banking prudence and propriety, different issues arise. All this having been said, it becomes apparent on a close and detailed examination of this voluminous record that the OIGB did not effectively bring its investigative and statutory powers to bear on the problem soon enough. The evidence was before the inspectors at least before the end of fiscal year 1984, and probably in fiscal year 1983, to draw the curtains on this bank before it had damaged those many businesses and persons who came to deal with it.

6. The Bank of Canada and the Ministers

The issues relating to these two bodies are nearly identical to those in relation to the same bodies in CCB. The salient facts have been referred to throughout this Chapter. The Commission comes to the same conclusions as to their respective roles in the CCB story, and accordingly, they are discussed here but briefly.

The Minister of State (Finance) received hopeful information about Northland in the Inspector General's September 1984 report. In March 1985, the Inspector General further reported on the rigorous audit of 1984 and the bank's improving profit picture. The Minister was made aware of the workout strategy in June and of the future values in August 1985. Based on the July and August discussions with Northland management, the failure to effect a merger, and information received from the Inspector General from the OIGB portfolio assessment, the Minister decided to close the bank. There is little evidence to suggest that Northland was closed in order to "take the political heat" for the two bank failures at one time. Simply put, the bank was insolvent and no workable solution was available. All this is verified by the curator's later detailed analysis of the loans. The Minister took the right decision and could not have been expected to act earlier given the information provided by the OIGB, and upon which, the two Ministers, in all the circumstances, were entitled to rely.

The role of the Bank of Canada has been referred to throughout. The same issues arise here as did in relation to CCB, and the same comments made there apply here.

Chapter 6

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Chapter 6

Recommendations

A. INTRODUCTION: THE TRIPARTITE SYSTEM

This Commission was asked to inquire into the causes of the failures of the Canadian Commercial Bank and the Northland Bank, and to make recommendations for changes in the regulatory framework insofar as they were called for by the evidence and submissions. The two banks investigated, by assets, represent a failure of less than one per cent of the Canadian banking system. The large banks in the system clearly are not exposed to the same serious risks which developed in CCB and Northland. The lessons which can be learned from the preceding narrative and findings relate mainly to the effectiveness and accountability of the regulatory processes and institutions which are entrusted with the supervision of the banking industry. Broader questions relating to the Canadian banking system and its associated regulatory environment, the ownership of Canadian financial institutions, the segregation of banking from other financial activities, the establishment of bank holding companies, and associated changes to financial institutions in Canada, are beyond this Commission's mandate.

The basic issue to be faced by the community is whether a bank is any different from any other commercial enterprise so far as government intervention in the case of insolvency is concerned. If the bank is seen as a quasi-public institution, analogous to a public utility, then the response is quite different than where the bank is seen as an ordinary example of private commercial enterprise. Most recently, this issue has been seen in debate in the United States. In that country, debate has moved into a second level. Assuming that there is a high degree of public interest in banking, such as distinguishes a bank from an ordinary trading corporation in the private enterprise market, is it even then permissible to segregate the banks into two groups, one group being seen as essential to the welfare of the community, and therefore placed in a "fail safe" or "no risk" banking category, and all other banks being classed as ordinary private commercial enterprises. Allowing investment in a bank which has been placed in one or the other category, when the investor does not know which category, raises a serious question of fairness. On the other hand, an investor in the banking field, knowing that the ultimate "fail safe" category will not be assigned to any bank until necessity brought on by imminent failure arises, will take his chances in investing in banking in the same way as he does in any other industry where risk prevails. Banking would then be a two risk industry. There is first the risk that the investor will choose the wrong category, and second, the normal risk that the bank chosen will go into default. However, the situation is not as unusual or unfair as that would indicate because in "essential bank" rescue programs, the investor of capital, as broadly hereinafter defined, loses out in the first round of the rescue. Where the troubled bank falls into the "nonrescue" category, the investor again will lose his investment depending upon the availability and extent of reorganization of the bank by private means. The depositor is insured in both cases so that his loss will depend upon the size of the deposit (except where made in a bank which thereafter comes under a bank assistance program as discussed later in this Chapter).

This nation already has a rough and rather primitive process for selection of banks for rescue. In the case of CCB and Northland, this selection and rejection was done at the political level where the responsible Ministers with prior government approval determined to rescue one bank, and later, not to rescue the other. In the United States, this decision is made administratively by the regulatory authorities. In England, the decision is made behind the thick screen of the Bank of England, and it is therefore difficult to determine the extent which the government of the day directs the decision of the Bank whether to rescue or not to rescue a bank on the brink of or in insolvency.

Lying at the bottom of all these considerations are political policies well beyond the mandate of this Commission. The extent of the regulatory system involving the licensing of new banks and its reach in the case of impending insolvency depends upon a number of factors including: (a) the degree of competition desired by the government in the banking system; (b) the need in regions of the country for locally based or locally oriented banks in order to extend the service beyond the larger centers of population; (c) the view taken by the government of the importance of the Canadian banking system in its international relations which may feed back into and enhance the desire to maintain the integrity of the banking system in the domestic arena; and (d) whether the government should adopt a policy of universal compensation for all depositors and investors other than equity holders in a bank such that the aperture of the rescue program will be much larger and the aperture for new entrants into the banking system much narrower.

Once it had been ordained that CCB would be the beneficiary of a rescue program and this decision was announced to the public, it became logically and perhaps politically inevitable that the government would either maintain the existence of CCB at all costs, or alternatively, would compensate all depositors of the bank should it ultimately fail. Thus, what has developed from this crisis is not so much a policy of universal compensation of creditors caught up in a bank failure, but the recognition that a decision to save a bank carries with it, almost inevitably, the obligation to either see the bank through the crisis one way or another, or to pay off in full all persons at loss in the failure, other than capital investors broadly defined.

So long as banks are to be commercial enterprises as now provided in the *Bank Act* they should be regulated so far as reasonably possible as being mortal in the same way as any other free enterprise. In some circumstances it will be in the interests of the community to let a bank fail. This is a bedrock discipline in the incentive system of commerce. If it is to be otherwise there would be no need for proprietary banks. It follows that an inspection system should not be so designed as to assure that whatever the cost no bank shall fail. Nor should the supervisor be so all-powerful and omnipresent as to effectively replace management and strip the bank of all enterprise. Ordinarly, free enterprise connotes the risk of failure. Banks should not be an exception to the theorem. The regulatory system is required to protect those who deal with the bank from impropriety and incompetence so far as reasonably possible. Some responsibility for reasonable conduct in their own affairs must be left in those who deal with the bank in whatever role or capacity. There is as well the need to balance the cost of a regulatory system against the risks to which the community should be exposed. This is a balance which has been long sought here and in other countries, and the recommendations which follow are advanced in the hope that a reasonable balance between risk and safeguards can be restored under the banking legislation.

For the purposes of proceeding with the development of a recommended design of a modified regulatory system, this Commission has assumed that the policies currently adopted, expressly or inferentially, will remain in effect in the foreseeable future. Therefore, it is assumed that the confidential supervisory system applicable to banks at present will be continued, and that given the appropriate circumstances in the future, the government of the day may determine to come to the aid of an ailing bank where its continued existence is considered necessary and advisable in the public interest. Other banks may be allowed to disappear through merger or liquidation or, most rare of all, by a simple surrender of charter.

Before dealing with the proposed structure for the confidential supervision of banks the alternative degrees of supervision should be examined. Much was heard in evidence of the contrast between the regulation of banks in the United Kingdom and in the United States, each of which have comparable financial institutions. As will be seen in Appendix B to this Report, the U.K. system upon which the Canadian regulatory agency was based at the outset, is a function of the central bank, the Bank of England. The central bank's inspection staff is small. The inspection concept is based upon moral suasion by the regulator and reliance by the regulator on management and on the external auditors for its information concerning the bank's operations. This is an economical system and appears, at least until recent years, to have served its constituency well. An increasing number of failures since the early 1970s, culminating in one serious and expensive failure in 1984, led to a re-examination of the concept in operation of the central bank's inspection service. Many of the recommendations made by a Bank of England review committee in 1985 and incorporated in a subsequent White Paper reveal a trend towards a more penetrating observation process in the bank supervision branch of the central bank, at least where the bank in question is assigned an unsatisfactory rating by the inspectors. The proposals made in the United Kingdom will, if adopted, partially separate bank supervision from the other functions of the Central Bank. They will also move the thrust and mechanics of bank inspections somewhat closer to the U.S. philosophy of inspection. The Inquiry has adopted some of the proposals of the Committee made in the U.K. studies in the following recommendations where those proposals would complement and fortify the Canadian format.

The U.S. federal bank supervision procedures are much more heavily slanted to the administrative process and involve very little political input from either the executive or the legislative branch. The inspection of banks, while confidential and based upon the prudential banking principles as in the United Kingdom, is not reliant upon management or external auditors for information, and indeed, the latter are rarely brought into the process at all. The public inspector performs a "hands-on" assessment, through its own staff, of the loan portfolio and loan management practices, and of the accounting principles applied by management in the preparation of the financial statements of the bank. This is a large and expensive business, although much of the cost at the federal level is borne by an assessment on the banks themselves. The cost is many times the proportionate cost of the Canadian system, where the costs are borne in the same way.

The federal/state constitutional authority is settled in a manner not dissimilar to the Canadian constitutional situation. What is very different is the proliferation of federal agencies engaged in banking supervision with some overlap and some confusion as to responsibilities. The several States likewise have supervisory agencies. Through a semi-formal association, the federal agencies have minimized the friction this complex machinery produces, although one expert from the United States described all this to the Inquiry as a "Rube Goldberg device that they would not wish on anyone". The relation between the federal regulators and state incorporated banks is contractual. State banks wishing to avail themselves of federal services, such as deposit insurance, voluntarily submit to federal supervision as a term of the plan. State and federal inspection of the state banks is coordinated on a semi-formal, but apparently effective, basis.

Because the U.S. supervision system is so expensive, and because of the relative smallness of the Canadian banking community, some of the features of the U.S. hands-on inspection philosophy are not here recommended. The Commission concludes that, on the evidence, the present basic principle of the tripartite system, as described in Chapter 3, should be retained. Radical change is not indicated. Defects exposed by these failures call for many adjustments as proposed below, but neither a return to the older English system nor the adoption of the "hands-on" U.S. system is recommended. While several elements of the U.S. federal regulatory system and some proposals in the U.K. White Paper seem appropriate for adoption in our country, and these are recommended below, this Commission has heard nothing in its review of the causes of failure of a small percentage of the banking system in this country which justifies the adoption of a fundamentally different kind of regulatory system. The question, really, is how to improve the present system and how to instill in the regulator the will to respond to the trouble signals.

The Commission has assumed, for the purpose of making these recommendations, that the existing structure of the financial markets and the overall design of the regulatory framework applicable to financial institutions will continue to exist in Canada. There are simply too many uncertainties regarding the future of Canadian financial institutions, including the retention of the "four pillars" philosophy, the impact of proposals for free trade in goods and services, and the development of international financial markets, to premise recommendations on what can only be a guess as to the outcome of the many current studies and proposals.

In addition to the evidence relating to the operation of CCB and Northland, the Commission has reviewed a considerable number of private and government studies of Canadian financial institutions and the regulatory environment within which they operate. While some of the reports dealt only with nonbanking financial institutions, several considered, in a detailed fashion, the supervisory regulation of banks along with other financial institutions. The Commission has drawn on these reports for the purpose of informing itself of current proposals for statutory amendment. The studies and legislation which have been reviewed are:

1. Interim Report of the Royal Commission to Inquire Into and Report Upon the Affairs of the Home Bank of Canada, 1924.
2. Report of the Royal Commission on Banking and Currency in Canada (1933) (The Macmillan Commission).
3. Report of the Royal Commission on Banking and Finance (1964) (The Porter Commission).
4. The Regulation of Canadian Financial Institutions: Proposals for Discussion, Department of Finance (April 1985) (The Green Paper).
5. Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC), submitted to the Minister of State (Finance), (April 1985) (Wyman Report).
6. Report on the Canadian Commercial Bank, House of Commons Standing Committee on Finance, Trade and Economic Affairs (June 1985).
7. "Canadian Financial Institutions", Report of the Standing Committee on Finance, Trade and Economic Affairs, respecting a Document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", (November 1985).
8. The Ontario Task Force on Financial Institutions – Final Report (December 1985) (Dupré Report).
9. Report: Subject-Matter of C-79, *Financial Institutions Depositors Compensation Act*, Thirteenth Report, Standing Senate Committee on Banking, Trade and Commerce (December 1985).
10. A study to Assess the Current Mandate and Operations of the Offices of the Inspector General of Banks (April 1986), prepared by Coopers & Lybrand for the Department of Finance.

11. Proposed amendments to the *Loan Companies Act*, the *Trust Companies Act*, the *Bank Act* and the *Quebec Savings Banks Act* in respect of certain regulatory matters, (April 1986) (Bill C-103).

12. Towards a More Competitive Financial Environment, Sixteenth Report, Standing Senate Committee on Banking, Trade and Commerce, 1 May 1986.

13. Financial Institutions in Transition: An Analysis and Commentary on Recent Proposals for Reform of Canadian Financial Institutions, prepared by Clarkson Gordon/Woods Gordon.

14. Report of the Committee Set up to Consider the System of Banking Supervision (United Kingdom) (The Leigh-Pemberton Report, June 1985).

15. White Paper on Banking Supervision (United Kingdom) (Cmnd. 9695, December 1985).

16. Blue Print for Reform: The Report of the Task Group on Regulation of Financial Services (July 1984) (The Bush Report).

17. Continental Illinois National Bank: Report of an Inquiry into its Federal Supervision and Assistance.

18. Staff Report to the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, H.R., 99 Cong. (1st Session) July 1985.

B. THE STRUCTURE OF THE REGULATORY FRAMEWORK FOR BANK SUPERVISION

1. Consolidation of Federal Regulators

The institutional structure for the federal bank regulatory system was the subject of a brief review in the Report of the Royal Commission on Banking and Finance in 1964, the main thrust of which did not concern the examination of loan portfolios, bank accounting and other matters associated with bank failures. Debate on the regulation of banking has recently been revived by the publication of the Green Paper on The Regulation of Canadian Financial Institutions in April 1985, after the CCB Support Program was in place. The Green Paper proposed the consolidation of the trust and loan company supervisory functions, now allocated to the Superintendent of Insurance, with the supervisory functions of the OIGB. The House of Commons Standing Committee, in its response to the Green Paper, went further, recommending the consolidation of the OIGB, the Department of Insurance and the CDIC into a single regulatory body performing supervisory, regulatory and insurance functions in relation to insurance companies, federal trust and loan companies, and banks. The Senate Committee, in direct contradiction to that recommendation, opposed a "single, all-powerful regulatory body", and recommended the retention of the existing regulatory structure.

There are five basic alternatives for the structure of bank supervision in this country:

1. Retain the Inspector General as a regulatory officer responsible to the Minister of Finance, separate from the central bank and insurance functions, perhaps with enhanced accountability through the establishment of an independent board of directors or similar internal governance structure.

2. Integrate the Inspector General's bank supervisory function into the Bank of Canada, coupled with the establishment of a committee of the Bank of Canada's Board of Governors to oversee the new supervisory function.

3. Establish a super-regulatory agency with jurisdiction over banks, insurance companies, and trust and loan companies as recommended by the House of Commons Standing Committee on Finance, Trade and Economic Affairs.

4. Adopt a market model of regulation through the establishment of a disclosure system at the national level which would regulate distribution of and trading in bank securities in the same way as any other business enterprise.

5. Combine the Inspector General's supervisory functions with the CDIC, which, as the insurer of the public's deposits, would determine its exposure to risk by its own supervisory activities.

This Commission heard considerable testimony and argument on the basic structure of bank regulation, and received briefs from many of the Inquiry's participants on this issue. The only conclusion which can be drawn from the materials considered is that no clear majority position has developed. The entire range of alternatives has been considered, without anything approaching unanimity from the major players in the Canadian financial industry. At the same time, it is recognized that the continued existence of a number of supervisory regulators can lead to unnecessary costs, and duplication of regulatory activities.

There was, admittedly, some support for the first option. The Royal Bank of Canada concluded that the OIGB should be combined neither with the Superintendent of Insurance nor with the CDIC. Several of the experienced bank auditors who appeared at the Inquiry similarly opted for the first alternative of leaving the inspection, insurance, and central bank functions separate. The Minister of Finance took the position that the functions of the Inspector General and the Superintendent of Insurance should be combined, leaving the present regulatory structure otherwise intact.

Notwithstanding those submissions, the present regulatory structure clearly has not succeeded in preventing the considerable expense associated with a serious disruption of Canada's banking system. The major difficulty appears to be not the lack of adequate information-gathering systems, but rather the failure of the Inspector General to respond to the signals as received. The question therefore reduces itself to this: How can one build into the present system the incentive and the will to intervene in a timely fashion so as to reduce to a minimum the risks to depositors and investors, and the cost to the community associated with the liquidation of a bank? The present system clearly does not represent the answer, and simply combining the functions of the Superintendent of Insurance with those of the Inspector General would probably be equally ineffective.

Nor is the alternative of reorganizing the OIGB to include an independent board of directors attractive. It would be difficult to interest experienced people with the qualifications necessary to make the agency more responsive to its designated responsibilities, but without conflicts of interest, to devote sufficient time and effort to the responsibilities of the office. Active bankers would, of course, have a direct conflict of interest of major concern if they were privy to current information from the regulated financial enterprises. Representatives of the other federal financial regulatory agencies would not experience this type of conflict, but would suffer from an added supervisory burden unrelated to their primary responsibilities. The business community would no doubt be the most fertile ground to explore for nominees to a supervisory board, but it would be difficult to find people whose experience would contribute to bank supervision. The position of a part-time member of such a board of directors would not likely be an attractive appointment in the minds of business and professional leaders, particularly where the board would have a very restricted policy input.

There was no support for the second alternative in any of the submissions to or testimony at the Inquiry. The major banks were ambivalent towards, and the CBA would not recommend, combining the primary regulator with the Bank of Canada. Similarly, the Minister of Finance, through his counsel, did not recommend this consolidation. Finally, the Bank of Canada itself, through the Governor's testimony, pointed out that there was perhaps an inherent conflict between the bank supervisory function and the role of advisor to the Government of Canada on monetary policy. However, the Bank of Canada and the primary regulator of banks come routinely into immediate contact and a large measure of harmonious cooperation between them is necessary. The Bank of Canada requires, and in fact obtains, details of the operations of the chartered banks which it reviews in connection with its functions relating to monetary policy and fiscal management of the national debt as the Government of Canada's agent. As well, the Bank of Canada must turn to the Inspector General under the present regulatory system for advice on the issue of bank solvency in deciding on the wisdom of continuing liquidity support. Further, when it requires information from the Inspector General pertaining to the value of the security, it must, under the *Bank of Canada Act*, take to protect the short-term loans it makes to banks as the lender of last resort. The Bank of Canada's need for advice and information with respect to members of the banking system on these matters is exemplified by the events surrounding the collapse of the CCB and the Northland Bank. Consolidation of the supervisory and liquidity support functions would have eliminated the exchange of correspondence, which took on almost comical proportions, between the Inspector General and the Bank of Canada concerning the solvency of these banks on 1 September 1985.

Despite these advantages of consolidation of regulatory functions in the central bank, the fact remains that the Bank of Canada's operations, as described in Chapter 3, seem to be devoted principally to the development of monetary policy, to advising the Government of Canada in that connection, and to the management of the national debt. There would seem to be very little mutuality of interest in regulatory and central bank functions, and very little in the way of mutual support between them. Indeed, as the Governor of the Bank of Canada and others in testimony and submissions have pointed out, an actual conflict of interest may easily arise if they are combined in the same body. Finally, the lack of enthusiasm for this solution amongst the leaders of the banking institutions, both public and private, cannot lightly be disregarded. While central bank and regulatory functions are combined, apparently without serious adverse consequences, in the United Kingdom in the Bank of England, and to some extent in the United States in the Federal Reserve Board (for further details on these systems, see Appendix B), evidence before this Inquiry does not reveal compelling reasons for restructuring the Canadian banking regulatory system along similar lines. It is noteworthy that in the United Kingdom, a partial separation between the inspection and central banking functions of the Bank of England has recently been recommended. Both the Leigh-Pemberton Report and the government White Paper on Banking Supervision recommended the installation of a semi-autonomous committee within the Bank to advise the Governor on the banking supervision function. That proposal is a blatant compromise between the desire to segregate inspection from central banking, and the desire to continue the traditional concentration of authority in the Bank of England. The experience in the United States is likewise of little persuasive value. There, the Federal Reserve Board, acting through its regional Federal Reserve Banks, is the lender of last resort and acts as the central bank, advising the government on fiscal issues and monetary policy. It also regulates state-chartered member banks in the Federal Reserve System through hands-on inspections. It is of some significance, however, that the principal inspection function in the United States, with regard to the nationally chartered banks, is discharged not by the FRB but by the Office of the Comptroller of the Currency. The FDIC supervises state banks which are not members of the Federal Reserve System but which voluntarily join the FDIC insurance scheme. The actual overlap between the central bank and inspection and regulation functions is not, therefore, as extensive as it would at first appear to be. There are, however, three federal inspection forces, one of which is operated by the FRB, the central bank.

As discussed in Chapter 4, it seemed natural in the eyes of all participants at the onset of the crisis of the CCB in March 1985, to turn to the Bank of Canada as a dominant central institution in the restructuring of the bank, and in the protection of the banking industry as a whole. However, the Bank of Canada had neither the statutory mandate nor the staff to lead in the design and implementation of a rescue program. Nor could it have supervised the ultimate liquidation of the two banks. The central bank had its own problems as a ranking secured creditor of these banks. The consolidation of primary bank regulatory functions currently performed by the OIGB in the Bank of Canada is therefore not recommended.

The mandate of this Commission of Inquiry is not sufficiently broad to require the examination of all the considerations which should be examined in order to form a judgment on the advisability of the third option, creation of a super agency at the federal level for the supervision, regulation, and control of all financial institutions. The Commission has, however, encountered functional considerations which appear to militate against the combining of the regulation of the essential banking functions and other financial, but otherwise wholly unrelated, functions of businesses such as insurance companies. This issue also raises constitutional and other important questions relating to federal-provincial policies with respect to the sharing of the administration of a field where there is increasing overlap in the market place between federally and provincially organized undertakings. No recommendation is here made in respect of this issue in view of the limited terms of reference of this Inquiry. It should be said, however, that nothing in the extensive record here established supports this third alternative.

The shift from confidential prudential supervision, which is the current basis of bank regulation in this country, to a surveillance and regulation of the banking system through a disclosure system oriented to security trading, is the fourth option. It, too, is well beyond the mandate of this Commission. The constitutional and other considerations associated with the issue of national securities distribution and administration are complex, extensive, and important, and have not been examined by this Commission of Inquiry. It may be noted that this matter has been under serious discussion in the United States, but the ultimate solution has yet to emerge.

Precedent can be found for the fifth alternative in the Federal Deposit Insurance Corporation in the United States. As will be seen in Appendix B, this is a large and highly regarded element of the federal regulatory system concerned primarily with the insurance of deposits in both federal and state banks, the latter being on a voluntary basis. The FDIC has built up a very substantial inspection service of some 1,500 inspectors who engage in the so-called hands-on supervisory system in the inspection of some 9,000 state banks. The FDIC also functions as the liquidator upon the insolvency of banks insured by it, however incorporated, and is the principal directing force in those rescue programs instituted where the federal agencies, mainly the FDIC itself, have determined that the bank in question is an "essential bank". Because we do not have the proliferation of federal agencies involved in the various elements of control of the banking system, in Canada the scene is much simpler, and the proposals which the Commission advances bring very little complication to the presently existing structure. The recommendation, as intimated above, commences with a basic acceptance of the present tripartite confidential supervision of the banks with modification of techniques and roles of the several participants, as indicated below.

After extensive deliberation, the Commission has concluded that, notwithstanding the absence of support for this concept from the federal agencies and departments, the most logical of the alternative courses of action identified above would be to transfer the OIGB, complete with its present powers, organization, and personnel, to the CDIC, to form in that agency an inspection division. This alternative alone offers both efficiency and a structure that would be responsive to the danger signals emitted by a troubled bank. It is suggested that the new agency should be named the Canada Deposit Insurance Commission (CDIC).

There should be no doubt that the consolidated regulator-insurer should enjoy all the regulatory powers currently exercised by the OIGB. It will also exercise additional regulatory powers, to be discussed below, in association with related issues and problems. As the existence, structure, and funding levels of the insurance function are beyond the terms of reference of this Inquiry, discussion of this alternative assumes the continuation of deposit insurance in its present form. Consolidating regulatory and deposit insurance functions would eliminate the conflicts of interest which present themselves in the second proposal considered above. Furthermore, by putting the insurer in a position to protect itself effectively through confidential supervision of the insured banks, this alternative recognizes and appeals to natural human instincts. It recognizes that the insurer has the incentive to act on information received to reduce to a minimum the risks it faces in any failure. It is precisely this incentive or will to act which was so graphically illustrated to be lacking in the institutional forms of the existing regulatory scheme.

The decision as to when liquidity advances should cease, and liquidation and insurance consequences begin, also seems naturally to center in the insurer. Although changes to the existing regime will be recommended, it is noted that under ss.27 and 29 of the *CDIC Act*, the CDIC may make application under the *Winding-up Act* for the appointment of a liquidator and may act as liquidator. In fact, the CDIC has not played this latter role, but rather has caused the appointment by the courts of an auditor-liquidator, or has acted as *de facto* liquidator itself when it is determined that the more economic route is the run-down of the assets and the ultimate surrender of the bank's charter instead of formal liquidation. Thus, the present law provides two routes which may be followed in dealing with an apparently insolvent bank. If clearly insolvent, the insurer can now, under its statute, institute the liquidation process on its own motion. If not clearly insolvent, or, if for any reason it may be impolitic to pursue this legally clear route, this issue may be transferred to the Minister of Finance by the Inspector General's recommendation for the appointment of a curator, and perhaps the commencement of liquidation proceedings. This approximates a crude and not very workable form of the "essential" bank process employed in the United States under the FDIC legislation. However, the U.S. pattern of decision-making relating to the termination of a bank is focused at the administrative, rather than at the political level.

In view of the considerations underlying its recommendations to consolidate regulatory and insurance functions, it is the view of the Commission that the new regulatory body should be subject to the direction and management of a small, highly skilled group of individuals. The CDIC will, as discussed below, inherit the function of the Inspector General of approving a prospectus in connection with the issuance of bank securities under the *Bank Act*. This is not so much a policy function as a protective procedure, administrative in nature, to ensure that investors in banks make their investment decisions on all relevant information. This same function is exercised by the provincial securities commissions. The bank supervisory function is also a protective function entailing little in the field of policy development. The supervisor is thus engaged principally in administering legislative policy as detailed in the *Bank Act*. These functions do not fit easily into the mould of a policy-oriented Crown corporation administered by a part-time board of directors. For these reasons the organization is recommended to be in the nature of a three-member commission, operational in nature, appointed on a full-time basis for fixed terms by Order in Council.

It is possible that the same self-interest which would motivate the CDIC to act expeditiously to enforce prudential banking standards might also, in certain circumstances, tend to lead it to disregard wider community interests which might be served by different practices. The *CDIC Act* currently provides, in s.11, that the CDIC may place public funds at risk only for the purpose of reducing a risk to itself. No such restriction on the provision of assistance to financially troubled banks should be included in legislation creating an insurer with primary regulatory functions. Rather, the legislation should provide that, in insuring a deposit-taking corporation, and in deciding whether and how to invoke regulatory powers in relation to such a corporation, or whether to recommend to the Minister the liquidation or termination of its business, the CDIC should have regard to a wide range of factors, including the national interest in the stability of the banking system as well as the likelihood of loss to itself. This would formally recognize in the system the so-called "essential bank concept" as a conscious step in the administrative processing of serious liquidity and solvency problems in a bank.

Recommendation 1

It is recommended that the supervisory functions now exercised by the OIGB be consolidated with the insurance functions now exercised by the CDIC in a newly constituted Canada Deposit Insurance Commission.

Recommendation 2

It is recommended that the regulator be a three-person commission, the members of which would be appointed by Order in Council and serve as full-time Commissioners for an appropriate term of not less than five years. The statute should provide that one such appointee shall be a banker of not less than ten years' experience in senior bank management; that a second shall be a member of the accounting profession and shall have not less than five years' experience in bank auditing; and that the third shall either be appointed from the insurance business with a minimum of five years' experience in senior management, or from the general business, professional or senior government service community. The Chairman of the Commission should be designated by Governor in Council, should serve for a term of five years subject to renewal for a further term of five years, and should also be the chief executive officer. The Chairman shall report and be responsible to the Minister of Finance or his delegate, the Minister of State (Finance).

Recommendation 3

It is recommended that the new agency be directed to take into account all factors affecting the public interest in exercising its regulatory responsibilities with reference to the financial conditions and continued existence of a bank.

2. Location of Regulatory Authority

At present, the offices of the Inspector General are located in Ottawa. However, the principal centers of banking are located elsewhere. By s.4 of its Act, the CDIC's Head Office is in Ottawa, but it may establish regional offices. All parties who have addressed the issue of the location of the regulator, including the OIGB, the Minister of Finance, and some of the major chartered banks, have recommended that regional offices be established. The same conclusion was reached by Coopers & Lybrand in their comprehensive study of the functioning of the OIGB. Decentralization of the regulator is the practice in the United States.

Recommendation 4

It is recommended that legislation constituting the regulator adopt the policy inherent in s.4 of the CDIC Act. The headquarters of the primary bank regulator should continue to be located in Ottawa, to facilitate the necessary dialogue between it and the responsible branches of government and the Bank of Canada, but the regulatory authority should be authorized by statute to establish branch offices anywhere in the country as required to assist in its inspection and supervisory functions.

3. Regulatory Personnel

The Commission has received detailed submissions on the staffing of the bank regulatory body. The present staff complement of the OIGB is widely perceived to be inadequate to the task of regulating the large number of Schedule A and B banks. To remedy this, it was proposed by the Canadian Bankers' Association, the OIGB itself, and other parties, that the staff of the regulatory body be augmented by the appointment of professional bankers and bank credit officers, auditors, financial analysts, appraisers, economists, and statisticians. The Coopers & Lybrand report on the OIGB recommended that the staff be increased from 42 to 73 members, and it would appear from submissions to the Commission that such an increase has been approved and that the engagement of suitably experienced personnel has commenced. The CDIC presently has a small staff of about 25. This represents a significant expansion in recent years. The insurer has developed considerable expertise in management of bank assets and is advised by a committee of real estate experts.

Since the events of 14 March 1985, the Inspector General, as well as the banks themselves, has acknowledged the need on occasion to perform on-site an examination of loan files of a bank. This move away from the U.K. tradition of supervision to something closer to the U.S. system is acknowledged by all players in the events leading to the closure of CCB, including the major banks who participated in the support program. It seems to be a permanent adjustment to the tripartite system of supervision and regulation, at least in the case of small or new banks where loan portfolios may not be diversified. This change should be reflected in the size and nature of qualifications of the staff of the bank regulator.

In the Commission's view, it is essential that the expertise referred to above be represented on the staff of the regulator on a permanent basis. However, its personnel requirements need not all be satisfied by the appointment of permanent staff members. Persons with experience as bank managers or executives, for example, may not realistically be available to the regulator on a permanent basis. As matters now stand, personnel of the OIGB are subject to Public Service Commission guidelines, and public service salaries in the relevant categories are not always competitive with those in the financial industry. Testimony from Canadian bankers and U.S. regulators recognized the difficulty of attracting and retaining such personnel in the regulatory staff. An executive interchange program currently in place in the Public Service Commission, whereby experienced individuals from the private sector are temporarily seconded to the public sector, has been extended to the OIGB. In submissions to the Inquiry, it has been recommended that this program be maintained and expanded. Other forms of exchange with the private sector are already in place or were recommended. The OIGB is presently making use of training programs sponsored by the CBA, by Canadian and U.S. banks, and by foreign (mostly U.S.) regulatory agencies. The Minister of Finance has indicated that an "executive interchange" program, which contemplates temporary secondment of permanent executive members of the regulator's staff to the private sector for training purposes, as well as the inflow of private sector executives to the regulator, is in the process of being implemented. A similar two-way secondment program was recommended for the British system in the Leigh-Pemberton Report. A group of recently retired bank credit personnel has been formed to assist the OIGB in loan examinations. Members of this group are being engaged as needed on personal service contracts to undertake special credit reviews. This source of the requisite skills has the advantages of availability and the absence of conflicts of interest.

It is agreed that there is a need for an increase in both the numbers and the expertise of regulatory staff, and for flexibility in achieving staffing requirements. The aim should be to establish a small but highly competent team of regulators, supported by a pool of independent, qualified personnel, for bank inspection as required. Two-way secondment between the regulatory staff and the banks would be mutually advantageous. This will entail the increase of both permanent staff and personnel engaged by contract for specific tasks.

Recommendation 5

It is recommended that the inspection staff of the regulator be increased by the addition of qualified and experienced bank auditors and bank credit officers. Existing staff expertise should be upgraded through access to appropriate training programs, whether developed by the regulatory body or offered

by private industry or foreign regulators. There should be maintained a program of personnel and executive exchange, either by two-way secondment or other arrangement between the regulator and the regulated banks, as well as a regular program whereby bank credit and audit personnel are used on a temporary or recurring basis in the examination of bank loans and other assets. Where use of active personnel is not practical, retired bank personnel should be engaged by the regulator as required.

4. Funding of the Regulator

At the present time, the cost of the inspection service of the OIGB is paid by levy on the banks. There has been no submission to this Commission that this system of bearing the cost be changed. The inspection service is no doubt run in the community's interest in sound banking as well as for the benefit of the banks themselves. Historically, the cost of service has been reimbursed from the banking system itself, although the scale of staffing and salaries has been determined by the Treasury Board. This system has perhaps provided a check or balance on the regulator and the Treasury Board in the establishment of appropriate staff levels. The Commission does not make any recommendations for change. By the continuance of the tripartite confidential supervisory system, the considerable cost of "hands-on" supervision in the U.S. style can be avoided, and the cost of bank supervision can continue to be borne by the banking industry, as at present. Likewise, nothing has been brought forward which indicates that the present system of funding deposit insurance should not be continued. As said at the outset, a continuation of the present depositor insurance is assumed for the purpose of considering matters within the mandate of this Inquiry.

Recommendation 6

It is recommended that the present system, whereby the cost of deposit insurance and of bank supervision is recovered by levies on the financial institutions covered by these services, be continued.

It can reasonably be anticipated that when the regulator in its newly-established form has absorbed the regulatory staff and functions of the OIGB, and consolidated its organization, it may well be determined appropriate for it to take over the inspection and administration on the same prudential supervision basis (modified as herein recommended) of all deposit-taking institutions within the jurisdiction of Parliament together with any other deposit-taking institutions

pool is reduced to two, and supplies only the second auditor. None of the banks saw any need for change in this pattern. On the other hand, the Commission has found nothing in the evidence or the documentary record to indicate any significant return to the bank or to the community at large from the presence of a second auditor, particularly where the lead auditor is effectively permanently installed through its reappointment year after year. In the two banks under investigation, the presence of two auditors did not seem to strengthen their position in settling differences with management relating to the financial statements. However, all persons who were directly experienced in the operation and in the audit of a bank strongly recommended against any change in the current provisions of the *Bank Act*.

Professional ethics ordinarily restrain auditors from acting in the audit of competitors. In banking, this does not seem to be a factor. The rotation heretofore has resulted in one firm being lead auditor or second auditor for more than one bank. With so many Schedule A and B banks, and so few experienced bank auditors, this is the inevitable result. There is more at issue here than the client's interest having regard to competitive and other considerations. It is a practical problem thus far without demonstrated deleterious impact on the public interest for which there appears to be no practical solution. With the practice of appointing lead auditors, the conflict will become more significant, where such an appointee serves in a like position for another bank, either Schedule A or Schedule B. The issue is less serious than would appear. Because of the scale of work entailed in the audit of a major bank, the appointments of bank auditors have devolved upon large audit firms. The designated partner/auditor will be different for each bank so that the work for each audit can be isolated. This appears to be the practical answer accepted by the bank clients.

Recommendation 20

It is recommended that no change be made to the dual auditor system as provided by s.237 of the Bank Act.

There are, however, two matters which do call for legislative consideration. First, it has been pointed out that the procedures set out in s.240 of the *Bank Act* are defective in several respects. This section permits, but does not require an auditor who resigns or is replaced, to report on the reasons therefor, and on the reasons why the auditor opposes any proposed action or resolution. This procedure does not apply where an auditor is simply dropped from the list of firms on the bank's normal rotation panel. Further, there is no requirement that the regulator interview the dismissed auditor.

established by a province where that province has entered into an agreement with the CDIC providing for the insurance and inspection of the corporations. The organization here recommended would be capable of undertaking the additional responsibilities.

5. Advisory Committee

The role of the regulator, constituted as described in the foregoing sections, will be important in maintaining the strength and stability of the Canadian banking industry. It is recognized, however, that the regulatory body must be responsive to the needs and realities of that industry as it constantly adjusts to the needs of the community as well as to Canada's international banking interests.

In light of the rapid transformation of the financial services sector and development of new investment instruments, it is unlikely that the regulator could, on its own, maintain full awareness of the developments in the industry. Once the essentials of the inspection and external audit system as described in later recommendations are in place, there should be established an Advisory Committee to assist the regulator in the performance of its regulatory responsibilities. While none of the reports which the Commission reviewed contain recommendations for the establishment of an Advisory Committee as such, some of the banks and other parties proposed the establishment of an advisory body of some kind. The CICA informed the Commission that it, in cooperation with the CBA and the OIGB, has established a task force to develop an Issues Paper to identify and examine the rationale behind the accounting principles and practices followed by Canadian banks. The bank auditor witnesses discussed the need for constant development of accounting and audit principles for the better administration of banking and bank supervision. The Commission agrees with these views and recommends the establishment of an Advisory Committee to function as an element in the regulator, providing support and advice on a continuing basis, relating particularly to the preparation and adoption of technical guidelines and the settlement of the many differences which arise in the application of the principles of accounting to banking and bank auditing.

The membership of the Advisory Committee should include representatives from banking, including bank management, auditors, and internal inspectors, from the auditing profession at large, and from the legal profession, and may also include representatives of the community interest generally. Appointment of its constituent members should be made by Order in Council. In particular, the Advisory Committee should be directed to respond to questions submitted by the

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The Commission accepts the importance of the role of the auditor in monitoring the financial position of a bank, and considers that it is imperative for the regulator to be apprised of the decision of a bank to replace an auditor, whether currently active or not.

Recommendation 21

To facilitate the protection of members of the panel of auditors, it is recommended that the Bank Act be amended to require a bank to maintain a panel of auditors from which its auditors will be recommended for appointment by the shareholders. Whenever an auditor is dropped from the panel or the rotation, the bank should be required to notify, in writing, the regulator, the members of its board of directors, and the auditor affected. The notice should include a statement of the reasons for dismissal or for the dropping of the auditor from the nomination rotation.

The regulator should be required to interview any auditor who is replaced or retired, to determine whether:

(a) there has been improper management interference with the performance of his auditing responsibilities under the Act; and

(b) the auditor was dropped or set aside for reasons other than his failure to discharge his professional responsibilities to the bank.

Some remarks must be made regarding the qualifications currently required of auditors. Section 238(1) of the *Bank Act* provides, *inter alia*, that at least two members of the firm of accountants appointed as a bank auditor must be "members in good standing of an institute or association of accountants" incorporated under provincial legislation, and have practised the accounting profession in Canada for six consecutive years immediately preceding the appointment of the firm. Under s.238(3), the auditor who is designated as the person who conducts the audit must specifically meet those qualifications.

The House of Commons Standing Committee, in commenting on the Green Paper, recommended that the federal regulator maintain a list of qualified auditors, and that the engagement of an auditor by a financial institution be subject to prior government approval. However, nothing that this Commission has heard suggests that the banking community or the accounting profession's self-regulatory procedures, and more importantly, the public interest, are in need of such extensive government assistance. The possibility of improper interference, perhaps regulator and to make on its own initiative recommendations concerning bank regulation, the supervisory system in all its phases, and principles of accounting applicable to deposit-taking institutions or which are generally applicable in the discharge of the statutory duties of the regulator. In addition to the specific issues which are herein recommended for referral to the Committee, the general responsibilities of the Committee should include the development of guidelines for bank accounting, internal control and audit systems and standards for bank auditing, the development of early warning systems for regulators and banks, and the provision of information to regulators about current developments in the financial services industry.

The Advisory Committee should have such staff, or access to such staff, as may be appropriate to its activities from time to time.

> **Recommendation 7**
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> ***It is recommended that an Advisory Committee be established, comprised of bankers, bank auditors, internal bank inspectors and accountants, lawyers and representatives of the community at large, to assist in the development of uniform guidelines for bank accounting, internal controls, and auditing, in the design of early warning systems and other returns, and in the improvement of published financial statements, and to provide the regulator with current information regarding the financial services industry. Appointment to the Committee should be by Order in Council on a part-time basis. As circumstances may from time to time require, the Committee shall have, or shall have access to, appropriate staff.***

C. INTERNAL BANK MANAGEMENT

1. The Structure and Composition of the Board of Directors

Currently, the *Bank Act* imposes few requirements on the composition and structure of banks' boards of directors. Restrictions on personal suitability are limited to requirements that bank directors be over the age of eighteen, be of sound mind, be natural persons, and not have the status of a bankrupt. Interlocking directorships with other financial institutions are prohibited.

Several proposals in relation to the structure of the board were made to this Commission. Specifically, it was proposed that the board of directors be required to establish committees to deal with sensitive or critical areas of operation in the bank, including non-arm's length and conflict-of-interest transactions, among other matters. The Senate Standing Committee on Banking, Trade and Commerce, in its report on the Green Paper, recommended a three-person business conduct review committee to review all non-arm's length transactions. The Dupré Report, on the other hand, suggested that such a committee would be inadequate to guard against self-dealing abuses.

A proliferation of committees on a board of directors is not necessarily a sound solution to specific problems. Where there is a non-arm's length transaction, the board sitting as such would appear to be the more appropriate forum, and the same considerations apply in connection with conflicts of interest. Certainly, there is merit in providing guidelines for the resolution of non-arm's length and conflict-of-interest issues, but there are no obvious advantages associated with delegating responsibility for these matters to a sub-group of the board.

Recommendation 8

It is not recommended that the Bank Act be amended to require the establishment of a committee of the board to review self-dealing and conflict-of-interest transactions.

A submission which does have merit would require that where the board of directors does establish a committee, the specific mandate of the committee should be filed with the federal regulatory body. This would afford the regulator a firm basis upon which to assess the committee's performance of its assigned responsibilities within the corporate government.

Recommendation 9

It is recommended that where the board of directors establishes a committee, the mandate of the committee should be filed with the federal regulatory body.

The Inspector General and the directors of the CCB and the Northland Bank have submitted that the Chairman of the board of directors of a bank should not also be its Chief Executive Officer. All of the major banks take the opposite viewpoint. Much can be said on both sides of this proposal. The Chairman who sits as CEO is indeed an imposing member of the board, and may perhaps be in a position to exert undue pressure on board members when matters critical of management are raised. On the other hand, the effectiveness of the board is no doubt enhanced by the leadership afforded by the CEO sitting as Chairman. The proposal would not, of course, exclude the CEO from the board, but would simply preclude the same person being the Chairman. While it is considered that this issue is an important one, no sufficiently clear case has been made out for such a legislative amendment.

Recommendation 10

It is not recommended that the Bank Act be amended to prohibit a bank's Chief Executive Officer from also holding the position of Chairman of the board.

In addition to these matters relating to board structure, the composition of the board membership raises interesting and important problems, particularly in a country of the size and diversity of Canada. The *Bank Act* is silent as to geographic representation and as to representation of major bank customers. In the CCB, the shareholders, by agreement and corporate provision, initially had the right to representation on the Board commensurate with their shareholding investment. By contrast, in the major banks there is no relationship between particular directors and particular shareholder interests.

Considerable testimony was heard at the Inquiry as to the advisability of avoiding what may be referred to, for the sake of brevity, as the "CCB organization" of the board of directors. The Green Paper proposal, which was adopted in the submission of the Minister of State (Finance), would require that directors have "an appropriate blend of expertise, experience, and personal suitability". The Commons Standing Committee would go even further, and would mandate the establishment of a governmental registry of "suitable" persons who could become bank directors.

Some submissions proposed instead mandatory regional representation, while the majority of submissions argued that no legislative action was required. It is concluded that there is merit in the practice of the major banks of ensuring a wide range of business and geographical representation on the board, but that it would be impossible to legislate a uniform standard of board composition for the private financial sector. The Commission does not consider that the evidence indicates a need for any specific statutory qualifications for bank directors other than the usual requirement that board members have the capacity to discharge their duty of care under s.54 of the Act. Section 35 of the present Act establishes a number of qualifications and disqualifications for directors, and the Commission sees no need to extend or modify those provisions.

Recommendation 11

It is not proposed that the Bank Act be amended to require additional director qualifications or particular board structures.

Section 36(3) of the *Bank Act* limits the permitted number of directors who are also officers or employees of the bank or of an affiliate of the bank, to 15 per cent of the board. This is required by the necessity for independent directors for functions such as membership on the audit committee. Section 36(3), however, additionally provides that "up to four persons who are officers or employees of the bank or of an affiliate of the bank may be directors of the bank if those directors constitute not more than one-half of the directors of the bank". This provision is sufficiently ambiguous to require revision. It may be that the regulator should be able to relieve against the 15 per cent requirement in special circumstances, but as the Act now stands it permits a bank to have 50 per cent of its directors drawn from the ranks of its employees provided that the board of directors does not exceed eight in number. Surely this is arbitrary and serves no purpose.

Recommendation 12

It is recommended that s.36(3) of the Bank Act be amended to provide that employees and officers can constitute a maximum of 15 per cent of the board, subject to exemption on the authorization of the regulator.

2. The Standard of Care and Fiduciary Obligations of Directors

Various submissions have been made to this Commission and in the numerous reports relating to regulatory amendment to the effect that the standard of care of directors stated by s.54 of the *Bank Act* in managing and supervising the affairs of the bank is in need of change. Section 54(1) of the *Bank Act* states that the directors must, in exercising their functions, "act honestly and in good faith with a view to the best interests of the bank" and "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." The first provision states the director's fiduciary obligation. The second, which is the only statutory statement by which the conduct of the board and its members may be measured, establishes the statutory standard of care in negligence.

The Green Paper proposed that the standard of care of directors be reformulated as that of "an experienced business person qualified to be a director of a regulated financial institution". As well, the Green Paper proposed that the standard of diligence be increased by requiring attendance at three-quarters of board meetings, and by requiring that directors be well informed of the affairs of the company, and question the accuracy of information where the experience of the director would suggest that it was open to question. The report of the House of Commons Standing Committee, although it differs in detail, also recommended increasing the standard of care of directors, as well as the required degree of attention to the affairs of the bank.

There are several serious shortcomings in these proposals. First, they are made without reference to their ultimate purpose. The proposals make no reference to the person or institution to whom the directors are to owe this duty. If the duty is to continue to be owed to the corporation, the proposals should say so. If the director is to be made responsible to his electors, the shareholders, the provisions should be drafted with that express object. Similarly, a proposal that the directors should owe a duty of care to depositors, as was suggested in some of the submissions at this Inquiry, should explicitly so provide. Under the current common law rules, the corporation itself has a right of action against the directors, enforceable directly by corporate decision or by a shareholder's derivative action in limited circumstances. The standard of care is meaningless without consideration of its ultimate beneficiary, and without consideration of the legal methods of enforcement of the legal responsibility. Although none of the submissions at this Inquiry have raised the issue directly, the procedural and practical aspects of enforcing existing legal duties are undoubtedly as important as a reformulation of the standard of care.

Second, it is necessary to appreciate the limited ability of the courts to review, with reference to an increased standard of care, the business judgment of directors and managers of private enterprises. Nor is it clear that it is appropriate for the courts to engage in that task in circumstances not involving dishonesty or abdication of responsibility known to the law.

Third, changes to the legal duties of directors must have regard to their practical limits. For example, if the burden upon a director is too high, either in criminal or civil law, then the likelihood of electing responsible, competent citizens to the board of directors diminishes. This is particularly so where the person in question may have assets which would be exposed to liability, and where there is uncertainty as to the availability or coverage of directors' insurance, whether due to the economics of the insurance industry or to legal impediment. The bare threat of exposure to litigation is serious. Even a victory in court can be financially crippling today.

Fourth, a real difficulty facing the legislature in these circumstances is the question whether the standard of care for members of the board of directors of a bank should be universal and equally applicable to all directors regardless of their experience, professional training, or position on the board. For example, it may be that a chartered accountant acting as chairman of the audit committee should have a higher standard of care than a member of a consumer's group, selected by reason of that interest or position in the community, who does not serve on a committee. It is not clear that revising or raising the standard of care alone would produce any worthwhile results.

Finally, it is not clear that the standard of care suggested in the Green Paper would in fact significantly change the judicial interpretation of the existing standard. The latter, as it is expressed in general terms, is capable of considerable flexibility as the circumstances of the case warrant. It is true that there is a dearth of case law holding bank and other corporate directors liable in negligence rather than for breach of their fiduciary duties. This would appear to indicate, however, not that the existing standard of care is inadequate to the task, but that the courts are, as noted above, properly reluctant to second-guess *bona fide* business decisions.

The majority of those presenting submissions to the Inquiry expressed themselves as being content with the present provisions of the Act. The Inquiry has not been persuaded that any significant benefit to the community would result from redrafting the legislative standard of care.

Recommendation 13

It is recommended that no change be made to the standard of care of directors expressed in s.54(1) of the Bank Act.

There remains the important issue as to what persons should be entitled to recover for losses occasioned by breach of the director's duty of care. The Commission is of the view that the identity of the beneficiaries of the existing statutory obligations owed by directors is of paramount importance, since it is through enforcement of private rights of action that the directors and officers of a bank will be disciplined. The current derivative and corporate actions are inadequate, and it would seem that the persons actually injured by a director's default, whether shareholders, depositors, or the bank itself, should be able to pursue legal remedies for compensation. Thus, the duty in the directors as described in the present Act should be maintained, but the Act should be amended to extend the duty owed by a director.

Recommendation 14

It is recommended that the Bank Act be amended to provide that directors owe their duty of care to the corporation itself,

to the shareholders and to the depositors. The enforcement of the right arising from the duty should be by way of civil action.

The question of enforcement of directors' responsibilities and duties in law is entwined with the position of others connected to corporate operations such as auditors, underwriters, officers and regulators. It is appropriate to deal with these questions at one time and this is done in connection with Recommendation 46.

3. Directors' Criminal Liability

It has been proposed to this Commission that criminal liability be established in the *Bank Act* for gross negligence or willful disregard of the statutory standards governing the conduct of directors. The House of Commons Committee recommended, along similar lines, that the *Criminal Code* be amended to impose liability for gross negligence and for the making of reports which create "gross misunderstanding".

There is, however, no serious gap in the existing criminal law which the suggested offence would fill. The existing *Criminal Code* provisions relating to fraud are applicable to the actions of bank directors, insofar as the bank is thereby dishonestly deprived of assets. As well, the issuance of a prospectus which fails to provide full disclosure of material facts may constitute an offence under s.358(1)(a) of the *Code* to the extent that the prospectus is intended to induce a person to purchase shares. Other *Code* provisions are applicable where appropriate. There are also relevant offence-creating provisions in provincial legislation including those regulating the issuance and trading in securities.

The majority of representations to this Inquiry have not favoured an expansion of the criminal law to regulate banking activities, and it has not been demonstrated that the ordinary criminal laws and provincial laws that apply to the conduct of members of the board of directors are in any sense inadequate.

Recommendation 15

No changes or additions to the existing criminal law provisions applicable to corporate directors are required, and none are recommended.

4. The Audit Committee

A considered and serious proposal was made to the Commission concerning the right and duty of directors to communicate directly to the federal regulatory body. In particular, extensive discussion centered around the responsibilities of the audit committee required by s.243 of the *Bank Act*. At present the Act is silent as to the responsibilities of the audit committee except that s.243(3) requires it to review the annual financial statement and other financial statements required to be submitted to the shareholders. The Act requires that it be composed solely of outside directors.

The audit committee, as an independent arm of the board entrusted by Parliament with special statutory responsibilities, represents a critical junction in the flow of information to the regulators from the auditors, the bank's internal inspection system and management. Both the important prudential functions of the audit committee and its links as a representative body of the bank with the regulatory body require amplification in legislation. In addition, its independence from management should be strengthened by a power to exclude management from its meetings.

Recommendation 16

It is recommended that the Bank Act be amended to state the terms of reference, in a general way, of the audit committee. These statutory responsibilities should include, as well as their existing responsibility to review the audited financial statements in consultation with the auditors, the review of the bank's policies in loan loss provisioning, asset valuation, income recognition by accrual or capitalization of interest and the taking of and accounting for fees, and the capability of the management information system to reveal potential problems in a timely fashion. As well, the audit committee should be under a duty to satisfy itself that the bank's internal audit and inspection systems are adequate and functioning properly. The audit committee should be required to meet with the bank's internal inspectors or auditors at least yearly and at any time upon request, and to report on such meetings to the board. The audit committee may in its discretion meet with or without management present.

An essential adjunct to these information gathering activities is the communication of that information to the federal regulator. Currently, under ss.242(3) and (4) of the *Bank Act*, it is the duty of the auditors to report to the Inspector General, "any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification", and clarification and enhancement of those reporting responsibilities will be recommended. The audit committee should be under analogous reporting responsibilities. The committee also should have a clear statutory right to communicate with the regulator at any time, and should be obliged to meet with the regulator in connection with the annual inspection of the bank. As well, the regulator should be able to meet with the audit committee and to attend any meeting of the board of directors.

Recommendation 17

It is recommended that the Bank Act be amended:

(a) to add a duty in the audit committee comparable to that provided in ss.242(3) and (4) of the Bank Act in the case of the auditors;

(b) to expressly authorize the audit committee to communicate with the regulatory body;

(c) to require the Committee to meet, and the regulator to attend the meeting of the Committee, after the annual inspection of the bank, at which time a detailed summary of the regulator's findings should be communicated;

(d) to provide that the regulator or the audit committee may requisition a meeting of the board of directors at any time on reasonable notice; and

(e) to grant to the regulator the right to attend any meeting of the board of directors of a bank.

5. Management Qualifications

It is trite to acknowledge that experienced and competent management are essential to the success of a bank and constitute the first line of defence against bank problems. Indeed this was acknowledged by all who testified on the subject before this Commission. However, no formal mechanism by which the suitability of management may be made the subject of regulatory investigation or approval presently exists. Under s.28 of the *Bank Act*, the right to carry on the business of banking and to exercise the powers set out in Part V of the Act is conditional upon approval or deemed approval of the Governor in Council, but no rules governing the exercise of this discretion are set out in the legislation. Only foreign bank subsidiaries must obtain an actual license in order to carry on business as a bank. The Green Paper suggests that, in the decision to grant or renew a license to operate a financial institution other than a bank, the appropriate regulatory authority should consider the sufficiency of skills, knowledge and experience, and the past performance of senior members of management. Such factors may be considered on an informal basis in the incorporation process applicable to banks as well, but clearly need not be under existing legislation.

Submissions at this Inquiry have recommended that the engagement of competent management with a demonstrated record in head office and branch banking, including competence and experience in loan valuation and credit management, should be a prerequisite to authorization to incorporate a new bank and carry on the business of banking. The Commission is in accord with these suggestions.

Recommendation 18

It is recommended that the Bank Act be amended to specify that no approval for the incorporation or commencement in business of a bank or for the renewal of its licence will be granted without confirmation by the applicant, on a confidential basis, that qualified senior personnel with banking experience, particularly in the field of bank credit management, have been or will be retained on a permanent basis.

6. Internal Inspection System

The *Bank Act* does not require an internal inspection and audit department or the appointment of a Chief Inspector by the board of directors of a chartered bank. As was stated in Chapter 3, however, it is nevertheless the universal practice among schedule A banks to appoint a Chief Inspector and a substantial inspection force, or equivalent internal department, to monitor the accuracy of financial results through development and policing of internal control systems. In addition, the Schedule A banks possess a credit audit system, which may be combined with the inspection department or may exist separately in some other department.

Submissions at this Inquiry by the Inspector General, the Minister of Finance and some of the major banks have proposed that appointment of an officer to head an internal audit or inspection system of the bank should be stipulated by the *Bank Act* in order to strengthen the internal inspection division's independence and authority. Further, it has been suggested that the legislation should set out the essentials of this officer's duty and functions. These would be to examine and evaluate the lending process, credit limits, and control systems generally. In order to discharge these functions, this officer would require access to detailed and statistical information concerning, among other things, nonperforming or other unsatisfactory loans, diversification of bank assets, the deposit base, loan loss provisions and write-offs, and general economic information and inter-bank comparative studies in the possession of the bank.

The head of internal inspection or audit should, according to these submissions, have access to all relevant bank records and be required to report to management on all matters of concern. The Act should clearly provide as well that he is under a statutory duty to file reports relating to his functions with the external auditors, the CEO, and the audit committee of the board of directors, without reference to management. The Commission concurs in these proposals.

> **Recommendation 19**
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> ***It is recommended that the Bank Act be amended to require that internal audit and inspection systems be established in each bank for the examination and evaluation of the loan portfolio, lending practices, credit limits and control systems of the bank, including the management information system. Personnel performing these functions should have access to all information in the possession of the bank necessary to permit fulfillment of these functions. The Bank Act should permit the Chief of these services to report directly to the CEO, the external auditors and the audit committee, as circumstances require, in respect of matters assigned to him, and to be available to the regulator at all times.***

D. AUDITORS AND BANK AUDITING

1. Appointment of Auditors

No one with experience in bank auditing who made submissions at this Inquiry has recommended the abandonment of the current dual auditor system. One bank auditing firm did, however, suggest that a panel of three auditors should provide the requisite two auditors on a rotating basis, and the Inspector General argued that the current practice of using a permanent lead auditor undermines the original purpose of the dual auditor system, which was to maintain a strong measure of independence of bank auditors.

The Senate Standing Committee on Banking, Trade and Commerce in its reports on the Green Paper and on Bill C-79, recommended that one of the two bank auditors be appointed by the regulator in order to enhance the independence of the outside auditors, and to introduce an audit perspective that takes into account the interests of depositors as well as shareholders. The House of Commons Standing Committee's Report on the same subject made similar recommendations, proposing that an auditor be appointed by and report to the federal regulator, arguing that this "regulatory auditor" would enhance the ability of the regulator to monitor the financial institution and introduce the prudential concerns of the supervisor into the annual audit. The Inspector General and Minister of Finance recommended the so-called Belgium system, involving the appointment of one auditor by the bank's shareholders, and another by the Inspector General. This second auditor would report directly to the Inspector General.

No other parties appearing before the Commission supported the proposal that this system be adopted, and several considerations militate against it. The Coopers & Lybrand study of the operations of the OIGB suggests that the introduction of "regulatory auditors" would require the development of an auditing mandate and auditing responsibilities which are different from those employed by professional auditors. As well, the existence of two auditing standards would make difficult the coordination necessary to develop joint opinions on financial statements, and indeed, would create additional problems in resolving any impasse arising between the two auditors' reports. The proposal would engender additional costs associated with overlapping responsibilities, and may present risks of political influence. It would additionally create difficulties in resolving the conflict of interest which arises when a bank auditor must value its client's loan from a client bank, although the ability of the present, two auditor system to solve this problem, given that each auditor has a duty to discharge its functions vis-à-vis the bank unfettered by other responsibilities, may be overstated. Finally, the *Bank Act* already provides in s.238 for the independence from the bank of the shareholders' auditors, and if the recommendations made in this Report which call for improved communication between the regulator and the auditors, clarification and strengthening of the reporting obligations of the auditors, and regulatory examination of the essential elements of the banks' loan portfolio are adopted, there would be little need for the appointment of an auditor by the regulator.

Since 1923, when the present pattern of bank supervision was established in Canada, the banks have engaged the services of two auditors instead of one as in ordinary business corporations, subject to the statutory rule that, if the same two audit firms have served for two consecutive years, one of the firms may not be appointed for the next year. In practice, most banks establish a pool of three or more audit firms who rotate through the two-year cycle. In recent times, there has been a trend at the major banks to appoint annually, but on a continuous basis, the same audit firm to act as lead auditor. Thus the rotation politically motivated, hangs over such a proposal. The auditor is required by the shareholders and the investing public. The regulator is required by the public at large. The two needs and the two bodies with respective mandates to meet these needs are separate and distinct, and should be kept so. Nothing heard in the extensive sessions of this Inquiry indicated a need for government intervention in the process of appointing shareholders' auditors or that the public interest would be served by such intervention.

Nonetheless, the level of bank audit experience is an important requirement if the auditor is to perform properly his responsibilities under the Act. The Coopers & Lybrand study has recommended that bank shareholder auditors be required to have extensive bank auditing experience. The Commission is in substantial agreement. On the other hand, regulations should not be so restrictive as to foreclose appointment of accountants who do not now audit a bank.

> **Recommendation 22**
>
> ***It is recommended that the Bank Act be amended to require that the auditor who is in active charge of the audit of the bank should have at least five years experience in the performance at a senior level of bank audits or audits of other deposit-taking financial institutions.***

2. Auditor Communication with Federal Regulators

Effective communication between the auditor and regulator lies at the heart of the regulatory process. In order for the regulator to perform effectively, the Act must be clarified so as to authorize mutual access between the regulator and the shareholders' auditors. Statutory direction and authority are necessary in order to free the auditor from the professional restrictions on release of client information. Sections 242(3) and (4) of the *Bank Act* require auditors to report to the OIGB on any transactions or conditions affecting the well-being of the bank that, in their opinion, are not satisfactory and which require rectification. Apparently no report has been filed in many years.

Some parties at the Inquiry took the position that s.242 did not necessarily create a positive duty in the auditors to make the reports described in the subsection. It is recommended that this section be amended to make it clear and certain that the auditor's duty to make reports under s.242 is positive, and that the auditor must, therefore, make such reports as are necessary to communicate the matters described in the section.

The Act should confirm that the shareholders' auditors do more than report on issues important to shareholders. Effectively, their reports are of interest as well to creditors, including depositors, the regulators and the general public. This may be achieved through increased and regular reporting by the auditors to the regulators. The Coopers & Lybrand study suggests that the OIGB should issue formal guidelines regarding the information and conditions on which the shareholders' auditors must report in fulfilling their statutory duties under s.242. The Commission supports this clarification of responsibilities.

Recommendation 23

It is recommended that s.242 of the Bank Act be amended to provide that the auditors be expressly required to report annually to the federal regulatory body as to the adequacy of the internal controls and inspections, the extent of the auditors' review of the bank's loan portfolio, any change in the bank's accounting policy, other matters specifically required by the Bank Act, and generally as to any matters which materially affect the bank's financial position. The auditors should be required to include in such annual report a statement that there are no other matters as described in the Act which require their comment, or, where no matters need be reported upon, the auditors shall so state in writing.

There is no validity in the argument that under the *Bank Act*, the regulator has insufficient power to ascertain particular aspects of the bank's business, including loan provisioning assumptions, security valuation practices, and the degree of fiscal conservatism characteristic of management. Section 242(2) permits the Minister to enlarge or extend the scope of the audit, and to direct any other examination to be made of the affairs of the bank, the expenses of which are charged to the bank. Section 246(5) authorizes the Inspector General to require information and explanations pertaining to the bank as he may require. Those sections are comprehensive in their scope, and while the powers expressed thereunder may not have been exercised in the case of the two banks under investigation, violation or failure to invoke is not an argument for a change in the statute. Accordingly, this Commission makes no recommendation in respect of those sections.

Communication flowing in the other direction from the regulator to the auditor is of equal importance. At present, the auditors are not necessarily cognizant of information relating to the bank in the hands of regulators. The *Bank Act* should be amended to require that the regulator inform the shareholders' auditors, as well as the bank, when the bank has been placed on a "watch list", and likewise inform the board of directors and auditors of the rating given to the bank at the annual inspection. This recommendation would complement Recommendation 30, which would require disclosure to the auditors of the regulator's findings after the inspection.

Recommendation 24

It is recommended that the Bank Act be amended to require that the regulator inform the shareholders' auditors, the Chief Executive Officer, and the board of directors of:

(a) the fact that the bank has been placed on a "watch list"; and

(b) the rating of the bank at the annual inspection, and any changes thereto on an on-going basis.

3. Accounting Principles

These were the subject of much evidence at the Inquiry. In some cases, difficulties were easy to define but solutions were not easy to develop. The important matters are reviewed here, and should be considered in conjunction with the current accounting principles, and the difficulties inherent in them and in financial statement presentation generally, as outlined in Appendix F. The more important items are gathered together in this section.

a. Generally Accepted Accounting Principles

Considerable testimony at this Inquiry described the differences between the accounting requirements of the banking industry and those of industrial and commercial enterprises in general. The result of these differences, some of which are expressly provided for in the *Bank Act*, is that the GAAP rules of the CICA are not entirely adopted in, or applicable to, the banking community. The Inspector General, some of the major banks, and several bank auditors have submitted that an advisory body should establish, so far as possible, bank accounting principles based on GAAP. The Commission accepts the validity of these submissions which are echoed by proposals in the Wyman Report and the Coopers & Lybrand study. The CBA goes perhaps further in adopting the premise that public disclosure by proper accounting principles is an important regulatory tool which brings market discipline to bear on the behaviour of banks. This is indeed the trend in the United States, and in self-imposed practices in bank reporting in annual and quarterly statements and reports in this country. Interpretation of financial reports will be facilitated by improvements which will bring bank practices and GAAP into conformity as far as is practicable. Of special importance is disclosure of the banks' financial status insofar as it relates to the generation of cash flow in contrast to reported income.

b. Loan Valuation

Loan valuation represents a sophisticated and complex exercise of judgment and experience. It lies at the heart of the assessment of the financial condition of the bank. When the debtor has defaulted or is expected to default in the foreseeable future, it presents considerably greater problems. These problems are magnified in view of the number and diversity of the loans comprising a bank loan portfolio. Considerable evidence was led describing the difficulties in determining the proper procedure to be followed in reflecting in a bank balance sheet the appropriate value of its loan portfolio. In the Commission's view, the evidence establishes that it is not possible to codify the exercise of judgment and experience inherent in the valuation of a borrower's covenant or the security underlying the covenant, where the former is unenforceable. This inability to codify opens up the possibility that the right to make the judgment will be abused if there are no standards by which to measure its exercise. In fact, it was the abuse of this "banker's judgment" that allowed these two banks to continue in operation in 1983, 1984, and through 1985. The solution may be a reduction of the process to general guidelines supported by clear prohibitions and illustrations of that which is acceptable.

A number of standards are applied in the industry in valuation of loan security. These include "current value", "market value", "liquidation value", "forced sale value", "going concern value", "realizable value", and "base line value". Meaningful terms which will satisfy the vocabulary habits of the banking, accounting and legal professions are difficult to find. This causes some of the confusion surrounding the whole valuation issue. Loan security valuation standards are required which recognize the need for a balanced and even-handed approach to asset valuation, in order to avoid precipitous securities rating and regulatory action. These principles and standards should not be established by legislative regulation, but should be the subject of guidelines issued by the regulator after industry consultation through the Advisory Committee.

Some generalizations applicable to the case where the value of the loan depends only on the value of the underlying security are possible. Evidence at this Inquiry suggests that it is generally unsound to base loan valuation on the valuer's optimistic view of the prospects of economic recovery in a region or industry. It is equally unsound, notwithstanding the recommendations of the Senate Committee's reports on the Green Paper and Bill C-79, to require that financial statements reflect only the current or market value of bank assets regardless of the state of the market which is generating that information. Valuation of real estate or other security should reflect the range of possible future experiences of the debtor, as well as the probability of their occurrence. It must be applied within a reasonable time frame, conservatively estimated. Where the collection of loans depends on planned events or probable developments, the valuation of such loans at the date of the financial statement should take into consideration the risks attendant on the forecasting of future events.

c. *Loan Loss Provisioning*

Considerable evidence was led at this Inquiry regarding the extent to which banks should be required to make provisions in the case of specific loans as well as in the case of entire industries or regions which may be subject to financial distress. This Commission accepts the recommendations of a number of the chartered banks, the CBA and bank auditing experts called by Commission Counsel, that there exists a range of acceptable amounts for any particular loan loss provision. To attempt to legislate loan loss provisioning would be, in effect, to attempt to legislate in detail the lending practices of the industry.

It is impossible to codify the exercise of judgment and experience inherent in loan loss provisioning. Rules, if they are to be effective, must be general and few. Provisions may vary from year to year, and must reflect the current status of each loan. They may be increased or decreased as circumstances require on an incremental basis, but they must always reflect sound, realistic, and somewhat conservative judgment.

d. *Accounting Treatment of Loan Losses*

One of the most confusing aspects of bank financial statements is the reporting of loan losses via the appropriations for contingencies account on the balance sheet. Under s.215(3)(c) of the *Bank Act* and the Rules for the Determination of the Appropriations for Contingencies of a Bank issued pursuant to s.308, loan loss experience is charged to the "appropriations for contingencies" account carried in the "Capital and Reserves" section of the balance sheet. The provision for loan losses, based on a five-year moving average of the loan loss experience, is then credited to the appropriations for contingencies account and charged to the statement of income. This has the effect of smoothing sudden increases in any given year in the loan loss experience of the bank.

In the case of the CCB, the appropriations for contingencies account declined in the financial statement for the 1984 fiscal year. At the same time, loan quality was deteriorating, and management was taking additional provisions against losses. All but the most sophisticated readers of the financial statement would understand this to mean that the bank's financial condition was improving when in reality it was deteriorating. This potentially misleading accounting device is unknown in the United States and the United Kingdom. In Canada, it is noteworthy that bond rating agencies, and no doubt most others in the investment business, when analyzing a bank's financial statements, immediately convert the figures to accord with ordinary accounting for bad debts and debt reserves. They thereby penetrate the fog surrounding the existing accounting procedures.

e. Accounting Treatment of Accrued or Capitalized Interest and Fee Income

Recognition of interest and fee income in bank accounting has been a major issue at this Inquiry. The use of less than conservative accounting practices involving the capitalization of interest and fees may result in the recognition of income of questionable collectability, and if so, these practices present acute problems in determining whether the resulting financial statements fairly and accurately represent the financial position of the bank. A descriptive disclosure of the quantified results of these practices would improve considerably the ability of the financial community and the general public to analyze the state of affairs of a bank. The further the statement of income diverges from a portrayal of the bank on the basis of its cash flow, the less useful it becomes. This is discussed later in this chapter. The Inspector General's Non Performing Loan Paper, which is briefly reviewed in Appendix F and further on in these recommendations, should be amended to reflect the additional income inclusion items disclosed by the evidence which are not dealt with in the Paper, and the methods disclosed in the evidence which could be used to ensure that various transactions fall outside the definitions contained in the Paper.

In this Section 3 of Chapter 6, the accounting and bank audit principles and practices most frequently discussed in the hearings have been reviewed. In the case of each of them, there is a history of professional development of the related accounting principles or doctrines. Any decision or recommendation relating to these highly technical matters should, if benefit is to be derived, come from a body trained in this discipline. Accordingly, the Commission has gathered up all these issues, and the discussions which have swirled around them, and now proposes that they be the subject of appropriate extensive professional study in the recommended Advisory Committee.

Recommendation 25

It is recommended that the Advisory Committee undertake a review of the following matters and report thereon to the regulator:

(a) Bank accounting principles which do not comply with GAAP, with a view to developing principles based to the extent considered desirable on GAAP;

(b) Loan valuation procedures;

(c) Loan loss provisioning practices;

(d) The abolition of the five-year loan loss averaging formula and its related apparatus; and,

(e) The capitalization of interest, the recognition of accrued interest, accounting for fee income, and the refinement of the Non Performing Loan Paper.

E. REGULATORY POWERS AND SUPERVISION

1. Introduction

Under the *Bank Act*, as outlined in Chapter 3, extensive regulatory powers are conferred upon the Minister and the Inspector General. As well, certain powers are conferred on the CDIC under its Act. In effect, these provisions provide the regulator and the insurer with power to obtain information and to levy the ultimate sanction: to terminate a bank's business. Neither the *Bank Act* nor the *CDIC Act* provides explicitly for an intermediate power to take early steps to avert disaster on the basis of information received. Nevertheless, submissions to the Commission by some of the chartered banks, the CBA and the CCB auditors indicated satisfaction with the present regulatory powers, and agreement that, in fact, the regulators and the Minister possess sufficient authority to regulate fully the banking system. McLaughlan, on the other hand, doubted that the existing powers were sufficient given the proliferation of Schedule A and B banks. There are instances in the evidence of the OIGB of difficulty in regulating Northland under existing powers, although this may be attributable more to a lack of will to act on the part of the OIGB than to a paucity of power.

Viewing the matter on the basis of pure legal theory, the Commission is inclined to agree with the assessment of the CBA, some of the chartered banks, and the CCB Auditors. However, even the fact of the debate itself regarding the extent of current regulatory authority leads the Commission to believe that more statutory precision would be desirable. In particular, the Commission has concluded that the regulator should be granted the express power to issue cease and refrain orders with appropriate appeal rights. More specific or precise requirements for regular routine filing by the banks of accounting information relating to noncurrent loans, workout arrangements, sale or transfer of assets on a non-arm's length basis or on an arm's length basis with significant bank financing, self-dealing, and other like matters should also be instituted.

In general, and with these limited reservations, the Commission is of the opinion that the present Act does indeed clothe the executive branch of government and the regulator of banks with sufficient powers to govern the banking system in the interests of the community. Equipped with ancillary powers and more express authority for intermediate intervention, the regulator would find more flexibility in the performance of his role. The more drastic the measure to be taken, the more reticence to take it. Degrees of response available to the supervisor will increase the frequency of response. This should promote the goal of timely intervention. This may be remedied most appropriately by institutional reorganization rather than by heaping powers upon the regulator. The following recommendations thus assume that the institutional reorganization recommended above, in particular, the consolidation of the federal bank supervisory authority and the CDIC, is implemented.

2. Incorporation and Licensing

Under the *Bank Act*, the decision whether to issue letters patent incorporating a Schedule A bank or to issue a license to a Schedule B bank is in the sole discretion of the executive branch. In the Commission's view, this branch of government should continue to be ultimately responsible for the decision to permit the establishment of a new bank. The experienced gained and lessons learned from the establishment of banks in the 1970s and 1980s strongly suggest that this decision should not be made without consideration of how the proposed new bank will operate in and affect the existing banking community. There are, at this stage, three relevant considerations. First, the proposed bank's objectives and intended business plan must be assessed realistically with regard to the existing market. Second, it must be established, as indicated earlier, that competent, experienced management will be in place from the date of the commencement of the bank's business. Third, the bank must be adequately capitalized. The Commission is of the view that these factors should be reviewed and reported on by the regulator to the Minister responsible before any decision is made on the application for letters patent or a license, as the case may be.

An increase in the capitalization now informally required of entrants to the banking market is recommended in the Wyman Report and by the Senate in its response to the Green Paper. Suggestions in the same vein have been made to this Commission by the Minister of Finance. The argument against imposing minimum capitalization requirements at the incorporation or licensing stage is that high capital requirements would exclude all but the largest institutions of the community from banking, and would tend to concentrate banking in the hands of a few established banks. Furthermore, capital requirements may fluctuate considerably once the business of the bank is underway.

Recommendation 26

It is recommended that no bank be established without consideration by the Minister of the views and recommendations of the regulator with respect to the proposed bank's objects, operational plans, management (including availability thereof), capitalization, and such other considerations as may be deemed relevant by the regulator.

3. Reporting Requirements

Reporting is the first phase of regulatory action. While the evidence does not reveal that the flow of information reported to the OIGB was a real problem in the failures of the CCB and Northland, it is nevertheless considered that the reporting systems now in place can be improved.

The premise of proposals to adopt an early warning system is that the collapse of a financial institution is a progressive process, rather than a sudden occurrence, and that it is possible to identify the decay of a bank's financial health at a relatively early stage. Early warning systems have, with the unexplained exception of the House of Commons Standing Committee's Report on the Green Paper, universally been acknowledged as an essential component of any effective regulatory process.

The early warning system now employed by the OIGB is made up of a multitude of ratios designed to assess capital adequacy, asset quality, management quality, earnings quality, and liquidity (CAMEL) prepared quarterly from returns submitted by the bank. It assumes that performance by the external auditors of their statutory responsibilities will reveal the condition of the bank's loan portfolio, and is dependent upon management's integrity for the accuracy of the information supplied. It cannot reveal management errors or improprieties relating, for instance, to inadequate loan loss provisioning or overly optimistic loan security valuations. Nor can it supply the will to act, or act as a substitute for judgment. What is required is the receipt of information from sources both inside and outside each bank. That information must be adequately organized once it reaches the regulator and must include the kinds of information vital to the assessment of the operations of the bank.

The banks suggest that an early warning system should concentrate on external signals independent of management judgment including interest rate spreads, cash earnings (in contrast to accrued earnings), the amount and cost of wholesale deposits expressed as a proportion of total deposits, and excessive loan concentrations by economic sector, geographical region, and borrower. Expert evidence on audit practices was to the effect that earning trends, the amount of capitalized and accrued interest, the number of loan workouts, the number of nonperforming loans and interest rate spreads were of special importance in developing an effective early warning system.

The banks also pointed out that signals appropriate to regional or newer banks may not be relevant to older, nationally diversified banks. The submissions of bank auditors emphasized the need for the computerized flow of information to the regulator. The Coopers & Lybrand study made the same point. At the present time, the OIGB has only just completed the expensive and lengthy task of converting from manual returns to computerized returns and analysis.

The Commission has earlier recommended expansion of the reporting responsibilities of auditors, the audit committee, and directors. Beyond that, a code of reporting requirements would be so complex, if it were to reflect all shades and nuances of what might be considered to be improper banking practices, as to be unwieldy. Indeed, in some cases it could operate as a serious impediment to managerial freedom, and would certainly generate substantial regulatory compliance costs. However, some order must be established so that all participants in the banking system, bankers and regulators, are aware of the rules of the game. Some banking practices have been described in the testimony as "bizarre", and must somehow be made the subject of mandatory reporting requirements to the regulator. The following subjects assumed some prominence in the evidence and the following potential defects were noted.

a. Loan Classification

Shortly put, not all bankers speak the same language. Appropriate regulatory response to information supplied by the banks would be facilitated by the establishment of a uniform system of loan classification to apply across the banking industry. Such a system would not be intended to act as a substitute for or to direct substantive management decisions as to the worth or riskiness of a loan. Rather, it is suggested that a uniform nomenclature be introduced to describe those management decisions.

A uniform classification system should evolve from recommendations of the Advisory Committee, and might take into account the views of this Commission regarding the definition of nonperforming loans as described below.

b. Nonperforming Loans

In 1983, in an attempt to supplement s.58(2) of the *Bank Act*, and standardize the reporting of problem loans by all banks, the OIGB developed the concept of a "substandard loan", which was used during 1983 and 1984 inspections. In 1984, the OIGB issued its Non Performing Loan Paper, which established expanded reporting requirements of nonperforming loans as therein defined.

The OIGB now accumulates quarterly reports, described in Appendix F, on loans on which interest is being accrued for more than 90 days. The reporting requirements present a reasonably accurate picture of the amount of nonaccrual loans, restructured loans, renegotiated reduced-rate loans, and accrued interest. While the reporting requirements now in place represent an improvement, they are deficient in some respects. Reporting based on loan classifications defined in terms of the accrual of interest can be avoided through capitalizing interest so that it is no longer regarded as contractually past due. Further, a loan might not be reported even though the borrower is not servicing it from his own resources.

It is essential to define a nonperforming loan so as to identify properly, on a statistical basis, truly damaging loans at the earliest possible time. The current definition of noncurrent loans in s.58(2) of the *Bank Act* is a good starting point because it focuses on payment required from the borrower's own resources, and has the virtue of imposing some discipline through requiring cash flow disclosure. However, the period of permitted arrears is too long for such loans to be effective as early warning signals. Various definitions were used in the CCB and Northland to allow them to carry a loan as satisfactory or performing, even though the borrower was not servicing the loan from his or her own resources. Such a practice may hide the rot in the loan portfolio until it is too late for the regulator to be of any help. It is recognized that overdrafts, independent loans, and other arrangements may cause a loan to fall into the noncurrent category without any impropriety so that no signal of loan weakness should be sounded. However, such arrangements, once disclosed, could readily be justified, and the requirement of explanation may itself be a helpful discipline. Some witnesses testified that while the concept of tracking loans not being serviced from the borrower's own resources is a good one, the mechanics of developing such a system, and the definitional problems inherent in it, were complex and would require further study.

c. Workout Disclosure

Loan workouts were these two banks' usually colourful and always ingenious and energetic attempts to nurse a bad loan along to the point where the borrower is able at least to meet his interest obligations. The Commission considers that potential workout abuses can be controlled by appropriate regulatory response to full disclosure. The monitoring of loan workouts is critical to an ability to assess the quality of the bank's loan portfolio, and thus the financial position of the bank. As noted in Appendix F, the current Non Performing Loan Paper issued by the OIGB does not apparently contemplate that all workout loans will be included within the definition of "restructured loans" required to be reported. Loans which are reclassified as coming from a different borrower, when that borrower has been funded by money coming from the bank, are apparently omitted. The reporting requirements should be expanded to encompass all workout arrangements. The definition of a workout arrangement should be designed by the regulator after consultation with the Advisory Committee on an ongoing basis. The Advisory Committee should have regard to all arrangements involving the renegotiation of a loan and any new loan to the original borrower or to a third party entered into after or in anticipation of default with a view to avoiding or minimizing a loss to the bank. Regard should be had to practices disclosed by the evidence, such as nonrecourse or effectively nonrecourse lending, and to the monitoring of the disposal activities of bank related or bank funded corporations having the mandate to dispose of bank security.

d. Principal Factors in an Early Warning System

The effectiveness of an early warning system will depend on whether it reflects, at the earliest possible time, a deterioration of the financial health of the bank. Information not vital to the detection of problems will glut the system. The main task, therefore, in designing an early warning system is to weed out information which does not reveal the health of the bank, or which by its nature comes too late to assist the process. The choice of constituent elements of an early warning system is an extraordinarily sophisticated and complex task. This Commission received submissions from the banks, the OIGB and the bank auditors on the components of the early warning system which should be implemented in Canada. The Coopers & Lybrand study also offered detailed recommendations on this issue.

It is not clear that the current practice of weighting all factors in the system equally should be retained. From the vast flow of data currently required from inspected banks, a number of principal signals should be isolated and emphasized. Evidence given by witnesses who testified on this matter suggests that these signals should include:

(i) Nonperforming or Unsatisfactory Loans: Reporting of loans in this category is the single most revealing factor in a bank, because the condition of the loan portfolio is the most important indicator of the bank's condition. Returns should reveal the net increase or decrease in nonperforming loans during the period reported on together with the number of such loans on the bank's books at the end of the period and the percentage of the loan portfolio they represent. The modifications that should be considered in defining these loans have already been discussed.

(ii) Interest Rate Spread: Banks should be required to report monthly, or even weekly, if feasible, the interest rates charged to borrowers and paid or offered to their various classes of depositors. This information will act as an early indicator that a bank is attracting deposits at uneconomic rates and/or making improvident loans. In view of the number of types of deposits, consideration should be given to reporting the rate for each class and the dollar amount in each class.

(iii) Accrued Interest: Accrued interest must be reported in a manner which reveals its age.

(iv) Capitalization of Interest and Fee Income: Compilation of capitalized income on an on-going basis is said to present none of the difficulties inherent in attempting to determine the amount of capitalized interest on a retrospective basis.

Guidelines and reporting procedures should be developed to identify interest and fee income recorded but not collected without bank funding. The reports should differentiate between fee income which is being amortized and that which is not, all to the end of revealing a fee income driven lending policy. Total capitalized and accrued interest differentiating between planned and unplanned capitalization, and total fee income in lieu of interest or received for *bona fide* services actually rendered must be reported so as to enable the regulator to assess the income statement of the bank as frequently as is feasible, but at least on a monthly basis.

(v) Loan Portfolio Growth and Diversification: Rapid growth in a bank's loan portfolio may represent substantial risks to the bank. Thus, any changes in the rate of the bank's growth should be reported to the regulator. Loans should be segregated by industry sector, geographical region, and borrower concentration.

(vi) Off-Balance Sheet Risks: Returns should reveal indirect liabilities, including guarantees and other commitments, direct and indirect, choate and inchoate, conditional and unconditional.

(vii) Loan Loss Experience: Loan losses recognized in each reporting period should be reported and compared to prior accounting periods both in absolute terms, as a proportion of the loan portfolio, and on a cumulative basis. A separate return should record the number and amount of nonperforming loans in respect of which no loan loss provision is taken.

(viii) Workouts: The number, and aggregate amount of loan workouts, as discussed earlier, should be reported. Data should indicate all workouts entered into in the reporting period as well as the total of such loans on the bank's books at the end of the period. Returns should net out worked out loans which have been restored to full performance and report these separately.

(ix) Earnings: The regulator should be able to generate a comparative analysis of earnings, showing trends in earnings in the bank, the ratio of earnings to assets, the ratio of noncash receipts to cash receipts, return on equity, and the differentiation between interest and noninterest sources of income. Noninterest income could usefully be broken down to its component parts.

(x) Liquidity: Exposure to liquidity risks is of major concern to deposit-taking institutions. Accordingly, the regulator should receive data describing the matching of the maturities of loan assets and deposit liabilities. Cash flow forecasts should disclose all assumptions.

(xi) Personnel: The regulator should monitor changes in directors, senior management, and auditors. Where changes are significant or indicate a trend, the regulator should determine the causes.

Much of the foregoing information is currently funneled into the present early warning system of the Inspector General. The emphasis now must be on highlighting, by a weighting system, the more revealing pieces of information such as the aging of accruals, the aggregating of unplanned capitalization of interest, and the deferral of provisioning against loans in partial and nonperforming categories.

Recommendation 27

It is recommended that the existing OIGB reporting systems be modified and extended to focus on factors of critical significance in a timely fashion. This should be implemented as follows:

(a) The Advisory Committee should have regard to the suggestions made above in formulating rules or guidelines relating to:
- ***(i) Loan Classification***
- ***(ii) Nonperforming Loans***
- ***(iii) Workout disclosure***

(b) The Advisory Committee should have regard to the evidence disclosed in the Inquiry, summarized above, in considering whether the currently existing early warning system should be streamlined and supplemented by the input of more meaningful information.

(c) The Advisory Committee should be directed to consider the advisability of a requirement that a bank, at the request of the regulator, should have all or some of its returns of information to the regulator certified by the external auditors, or, at the election of the regulator, by a senior officer of the bank.

4. Selective Supervision

Experienced bankers and banking auditors testifying at the Inquiry were uniformly of the view that the intensity of regulatory supervision, and the frequency and nature of inspections should reflect the quality, stature, experience, and other characteristics of each regulated bank. Newly established banks may require something approaching the U.S. system of hands-on supervision. On the other hand, the large banks with long established staffs and operating systems require much less supervision, perhaps requiring comprehensive inspections less frequently than annually in something approaching the existing Canadian system modified as recommended. Generally, in the case of mature banks the regulators may be able to rely to a considerable extent on information supplied through the established banks' auditors and internal systems, with recourse to loan examination only exceptionally or on a test basis. In the case of new banks or banks which concern the regulator for any reason or are on a watch list, however, a different intensity of supervision must be considered. The level of inspection should represent a variable scope of activity and not a fixed standard of intensity. Accordingly, the regulator should develop a spectrum of inspection activity for all the banks under its supervision. The scale and form of supervision will vary according to the position on this spectrum of each bank at the time in question.

Recommendation 28

It is recommended that supervisory and investigative powers be exercised in a manner responsive to the financial condition of the bank, its maturity, size, asset quality, the diversification of its loan portfolio, and its condition as revealed in the early warning system.

5. On-Site Inspections

The Commission does not recommend the abandonment of the basic tripartite system of bank regulation. However, one of the lessons to be learned from the difficulties surrounding the CCB and Northland Bank is that the regulator must have the resource capacity to move into the bank and satisfy itself of the true condition of the loan portfolio when circumstances warrant. The OIGB, in 1985, responded to the need to evaluate the loan portfolios of these two banks through the employment of active or former bank credit officers during the planning and operational stages of the CCB support program and in assessment of Northland Bank. The evidence is clear that an earlier outside and objective assessment of the banks' loan portfolios would have caused the OIGB to change its view of these banks radically, and at an earlier date. As described in Chapter 3, the practice of on-site inspections has grown through 1985 and 1986, and has been extended to all banks in the system, even the major national banks. It is noted that the United Kingdom is seeking to modify its regulatory system to incorporate similar on-site inspection powers and capacity.

The on-site inspection power suggested here will be of use in conjunction with the system of selective supervision described above. It should be used as required through the life of the bank as well as in pre-liquidation loan portfolio valuation, as it is certain that if on-site inspections become associated solely with emergency situations, as suggested in the House of Commons Finance Committee's Report, they will merely become a signal to the financial community of impending failure, and the deposit run will be on. The omnipresent realization in a bank of possible unannounced loan examinations would by itself exert a salutary influence on the conduct of a bank's business.

Recommendation 29

It is recommended that the OIGB continue to enlist, on a contract basis, the services of active and retired bank credit and management personnel in supplement of its own inspection staff as required, for the performance of on-site assessments of the banks' loan portfolios. On-site inspections should occur throughout the life of each bank at frequencies reflective of the bank's condition as earlier recommended, and should not be reserved solely for emergency situations. (See also Recommendation 5, above.)

6. Annual Inspections

It is currently not the practice for the report prepared by the OIGB following the annual inspection of the bank to be communicated to or reviewed with representatives of the bank, although regulatory personnel do conduct "wrap-up" discussions with senior bank officers. The CCB auditors have submitted that the results of the annual report should be communicated directly to the CEO of each bank and to the shareholders' auditors. The OIGB has indicated that it intends to send letters detailing its inspection findings to the banks. For greater certainty, amendment to s.251 of the *Bank Act* may be necessary or advisable to allow expressly this and other communication recommended earlier between the regulator and the bank and its auditors.

Recommendation 30

It is recommended that the regulator be required to disclose to the bank a summary of its findings after the annual inspection. The summary should include the rating of the bank and should be directed to the senior management of the bank and to its shareholders' auditors. This summary should be the subject of a meeting of the audit committee, attended by the regulator, as earlier recommended. The disclosure of this information by the banks, in turn, will be as directed by the regulator on the same basis as in the case of a cease and refrain order. (See also Recommendations 17 and 24, above.)

7. Cease and Refrain Orders

Throughout the hearings before this Inquiry, much was made of the power of the FDIC to issue "cease and desist orders" such as the order issued against Westlands Bank. The FDIC order was detailed and comprehensive, and expressly dealt with valuation of loan assets in the bank, along with a series of related measures aimed at restoring the bank to financial health. In fact, this objective was achieved. While all of the reports on regulatory change have advocated the adoption of this regulatory tool, there was a sharp division of opinion before the Commission as to whether it should now be expressly granted to Canadian regulatory authorities, and not left to inference. The OIGB proposed for clarity and certainty that the *Bank Act* be amended to include the power to issue "cease and refrain" orders.

Most of the major banks and the CBA have proposed that any power to issue cease and refrain orders should be limited to issues of insolvency (although the Inspector General testified that at that stage, cease and refrain orders are of little value), that they be confidential, and that there be a right of appeal. Bill C-103 would authorize a "direction of compliance" to be issued to stop, prevent, or require action to revise "an unsafe or unsound practice in conducting the business of the bank". Such a directive would not be required to be made public, and would be subject to appeal.

It is the Commission's view that effective regulation requires the regulator to have the proposed range of enforcement tools available throughout the bank's life in addition to the ultimate power now given by the Act to close the bank.

Recommendation 31

It is recommended that as contemplated by Bill C-103, express authority to issue cease and refrain orders should be provided to the regulator. Use of this power should not be restricted to cases of threatened insolvency. Rather the regulator should be encouraged to use its powers at an early stage when improper practices may still be successfully reversed. Any such orders should be subject to appeal.

A difficult issue arises with respect to whether cease and refrain orders should be made public. Unquestionably, without statutory or regulatory exemption, a cease and refrain order, depending of course on its content, would have to be disclosed in a prospectus or as a "material change" under securities legislation, which focuses on public disclosure and therefore requires the revelation of all outstanding orders, obligations, undertakings and requirements which are deemed to be material. A further question arises whether cease and refrain orders, when taken to a court on appeal or review, should be made public. The issue is important because a comprehensive cease and refrain order would in all probability indicate severe weaknesses in the bank and could prompt a run on even a large and well established bank. All these matters have been extensively discussed in regulatory circles in the United States, as reviewed in detail in Appendix B.

In view of the provincial regulation of securities in this country, if cease and refrain orders are to be adopted under the *Bank Act*, protective provisions may be required to avoid premature disclosure of the existence of an order. The consequence of disclosure in banking might, in some circumstances, cause a run on deposits. On the other hand, any restriction on publication would penalize, or at least jeopardize, investors who would be kept in the dark about matters sufficiently serious to trigger the issuance of a cease and refrain order. Parliament will appreciate this serious practical problem, and that a compromise or balance must be achieved between full access to information by the share investor on the one hand, and systemic integrity of confidential supervision on the other. It has been suggested that a compromise might be to grant protection from disclosure unless the order is taken to judicial proceedings by appeal or review. Some information supplied to the Commission indicated that this was the solution in the United States. However, as described in Appendix B, this does not appear to be the case today. On reflection, the Commission has concluded that the potential impact of a cease and refrain order will ensure its use only when real need is demonstrated. In such circumstances, a bank which faces this drastic remedy should face the consequences of its recalcitrance and previous noncompliance with informal directives. This is the very basis of the system of protective surveillance. Of the other investigations and examinations made in the regulatory framework, which have not been reduced to a cease and refrain order or directive, no disclosure by the regulator or the bank (unless so directed by the regulator) should be required.

Recommendation 32

It is recommended that cease and refrain orders be disclosed forthwith upon their issuance unless otherwise ordered by the regulator as the circumstances may require; but administrative action by the regulator not resulting in a cease and refrain order will not be disclosed by the regulator or by the bank except as directed by the regulator.

8. Asset Valuation

Considerable discussion arose in the course of the hearings as to the practices of the CCB and Northland Bank in valuing their loan portfolios. Difficulties arose from a number of issues, the more important of which related to loan restructuring, loan loss provisioning, and recognition and capitalization of interest and fee income. In all these processes the same problem arose, namely determining the worth of the collateral, usually real estate. Very few submissions were made, and fewer proposals offered, as to the solution to the problem of valuation, whose complexity in the circumstances of an ailing bank is amply demonstrated by the evidence before the Commission.

Bill C-103, the deficiencies and impact of which are considered in Appendix F, proposes to arm the Inspector General with power to determine the value of a bank's assets. The power is ambiguous as proposed, and in any case, reaches far beyond anything which has been suggested to the Commission as being necessary for the advancement of either the banking system or the public's interest therein.

The Commission is of the view that cease and refrain authority will enable the regulator to control security valuation practices so as to ensure the prudent conduct of the business of banking. This authority should be given a fair trial in the regulatory system before a measure as drastic as the power to actually restate the value of an asset is given to a public authority. Consistent with the Commission's affirmation of the basic tripartite structure of the Canadian banking system, prudent and appropriate loan valuation procedures will best be ensured through competent bank management decisions rather than through regulatory fiat.

Recommendation 33

It is recommended that the proposed amendment to s.175 of the Bank Act in Bill C-103 to empower the regulator to determine the value of a loan not be adopted.

9. Substitution of Management and Directors

The Department of Finance in the Green Paper, and the Minister of Finance at this Inquiry, have recommended that the regulator be given the power to replace management and members of the board of directors. This general power is possessed by some U.S. regulators. The Commission recommends below that this power be accorded to the Minister of Finance in a bank assistance program only. There is nothing in the extensive record to warrant a conclusion that the Canadian banking system requires, in the public interest, this unusual and serious invasion by regulatory authority in circumstances other than in a bank assistance program. Indeed, having regard to the dramatically different make-up of the banking scene in the United States and Canada, such a measure seems wholly inappropriate to Canadian circumstances at this time. In the one instance where the regulator had occasion to consider the removal of a senior officer in a bank (CCB), the desired result was achieved through the existing regulator-management relationship without the existence of any specific power in the regulator.

More importantly, the Commission has recommended the power in the regulator to issue cease and refrain orders. Such power has been employed on occasion in other jurisdictions to achieve the removal of management or directors. This new authority should be given an opportunity to function before resort is taken to the extreme extent proposed in the Green Paper.

10. Control of Self-Dealing

Self-dealing in the form of transactions between the bank and its directors and officers, or persons or corporations related to its directors and officers, may amount to a breach of the fiduciary obligations imposed by s.54(1)(a). Such transactions are, however, permitted by the *Bank Act* in certain circumstances. Section 174(2)(f) imposes limitations on the terms and conditions of loans to inside directors and officers. Such loans must either be secured by a mortgage or hypothec on the ordinary residence of the debtor, or not be in excess of the debtor's annual salary paid by the bank or $25,000, whichever is greater. Section 174(2)(g) is directed to loans to outside directors, and provides that they must be made on terms and conditions applicable to loans made in the ordinary course of business. Such loans are also subject to a monetary limit expressed in terms of the total capital and surplus of the bank. The aggregate amount of loans outstanding to directors is information required to be kept at the bank's head office and made available to the public upon request under s.215(7) of the *Bank Act*.

Control of self-dealing in its various forms has been the subject of recommendations in the Green Paper and the reports following it. The authors of the Green Paper proposed that self-dealing should be presumptively banned, with very limited exceptions. The industry's response to this proposal, as reflected in submissions at this Inquiry, has been negative. The chartered banks asserted that self-dealing can most effectively be controlled through maintaining the ownership restrictions applicable to Canadian banks. According to testimony given by several of the CEOs of these banks, the first line of defence against improprieties is sound management, beginning with the board of directors and including the senior officers of the bank and its chief inspector and inspection department. They have testified that when this system of managerial discipline breaks down, it is difficult to prescribe a substitute in the form of third party regulation.

There is no clear demonstration in the record that any financial evil befell the CCB, Northland Bank, or anyone involved in the banks by reason of borrowing by directors or officers. There is, however, the obvious consideration that a director or senior officer who is significantly indebted to the bank must lose some independence and credibility in the ongoing debates in the bank concerning other loans, and loan granting and collection practices among other subjects. In Northland Bank, loans to directors amounted to about $7.5M by 1985. Loans to officers at the same time amounted to over $2M. The details of these activities are found in Chapter 5. The manner in which some of these loans were authorized by the Board of Directors raises serious questions about the susceptibility to control of this type of lending in a small bank such as Northland. While this may not be a problem for large banks, the Commission has concluded that loans to outside directors should be prohibited. This has the clear advantage of ease of administration. It is not considered feasible without much further study of the problem to attempt to control further loans to entities controlled by directors. The provision in s.174(2)(f) is adequate to protect against abuse in loans to inside directors and officers. An exception should be made to this ban, however, where the purpose of the loan is to enable the director to purchase shares in the bank. Under s.42 of the *Canada Business Corporations Act*, a solvent corporation may make loans for this purpose to its directors.

While some proposals were received by the Commission with respect to the control of lending by banks to affiliated companies, no evidence was directed to this issue because neither bank made such loans to any significant extent. Certainly nothing in the evidence reveals any connection between these bank failures and improper loans to subsidiaries (other than in the workout situation and Westlands, both addressed elsewhere) justifying a recommendation on this aspect of the subject.

A ban on all outside loans to directors will not prevent them from obtaining justifiable terms from other institutions. Of course the banks may syndicate their lending to officers and directors among themselves so that no bank makes loans to its own directors but may make loans to those of other banks. Even if this were done on a reciprocal basis, it would at least remove the fetter on the freedom of debate and vote at board meetings. If favourable terms are sometimes viewed as partial remuneration of members of the board, there is nothing to prevent more direct means being adopted to achieve the same ends.

Recommendation 34

It is recommended that the Bank Act be amended to prohibit banks from making loans, on whatever terms, to nonemployee members of its board of directors, except for the purchase of shares in the bank by the director. The restrictions on loans to employee board members which are now imposed by the Bank Act should be retained.

11. Regulation of Lending Practices

a. Loan Concentrations to Individual or Connected Borrowers

Lending substantial amounts to single, or to related or connected borrowers, leads to concentration of loans and is an obvious risk to the stability of a bank. At present, there are no statutory limitations on the amount or percentage of a bank's capital that can be loaned to any one borrower or group of connected borrowers, although bank auditors have a duty, pursuant to s.242(3)(b), to report on the existence of loans to one person exceeding 0.5 per cent of the total of paid-in capital, contributed surplus and retained earnings of the bank where, in the auditors' opinion, loss in respect of those loans is likely to occur. This may be contrasted with the position in the United States where, under 12 U.S.C., s.84, no national bank may lend to any person, co-partnership, association or corporation more than 15 per cent of its unimpaired capital stock and surplus.

Various proposals have been made to the Commission recommending the implementation of similar limits on Canadian chartered banks. The Commission is in agreement with these submissions.

Recommendation 35

It is recommended that the regulator, after consultation with the Advisory Committee, recommend to the Minister that regulations be made to establish reasonable limits on lending to individual or connected borrowers, expressed as a percentage of defined capital.

b. Regional and Sectoral Lending

Evidence as to the impact of the economic recession in Alberta and British Columbia on the CCB and the Northland Bank led to argument and submissions relating to the application of loan loss provisioning on a sectoral basis, much as provisioning is required in relation to sovereign loans pursuant to guidelines promulgated by the Inspector General. The Coopers & Lybrand study concluded that certain industrial and economic sectors lend themselves to general provisioning. Only one submission to this Commission adopts a comparable view. The Toronto-Dominion Bank's practice is to take minimum provisions automatically on nonperforming loans in specified sectors and regions. U.S. regulators recently authorized sectoral provisioning in agriculture and energy industry loans. Other submissions have indicated that there would be value in general limitations on the powers of a bank to concentrate lending to borrowers in cyclical economic sectors or in certain geographic regions.

The Commission is of the opinion that no such limitations should be imposed. Either mandatory provisioning or restrictions on lending, without reference to the state of the individual loan would, as testimony offered on behalf of some of the chartered banks indicates, be seen as penalties limiting the growth of these economic sectors or regions. Risks inherent in lending exposure concentrated in this way may be controlled to the extent necessary by adoption of appropriate internal prudential management practices, and surveillance and regulatory action where necessary. Loan concentrations will be reported to the regulator as part of the early warning system, and significant sectoral or geographic exposure will be considered by the regulator in determining appropriate levels of capital and leverage ratios for each institution.

Recommendation 36

It is not recommended that statutory amendments restrict bank lending in particular sectors or geographic regions. Nor should the statute require automatic loan provisioning on a sectoral or regional basis.

c. Workouts

Some of the chartered banks have submitted that a bank should be unimpeded by legislation in its decision as to how workout arrangements are to be structured, and particularly in its decision whether to take an equity position in the workout scheme. The bank, it is said, should be free to take whatever steps are reasonably and prudently necessary to afford the borrower an opportunity to meet his obligations. The freedom of the bank to enter into restructuring agreements, corporate reorganizations, and other remedial measures, instead of resorting to foreclosure or other loan enforcement mechanisms, is said to be essential to good banking practice, and to be in the community interest as well. The Commission agrees with this submission, and considers that potential workout abuses can be controlled by appropriate accounting rules and by increased regulatory surveillance leading, where appropriate, to write-offs or provisioning. These matters have been discussed earlier.

Recommendation 37

It is recommended that banks should not be constrained in the development of workout strategies, subject always to full reporting as earlier recommended.

12. Reports from Foreign Regulators

CCB's auditors have submitted that Canadian bank regulators should routinely forward information received from foreign regulatory bodies concerning specific banks to the auditors of those banks. This is a delicate problem, as some foreign regulators, notably those in the United States, may attach strict conditions to the use of information they disclose to Canadian bank regulators. The FDIC and FRB stoutly refuse to allow the Canadian head office of a bank operating in the United States, or a Canadian regulator of such a bank, to retain copies of annual or special reports by their agencies. U.S. regulators see no need for reciprocal disclosure by Canadian regulators. The result is that the Canadian bank regulators can rely on very little continuous support from U.S. regulators.

This issue raises complex questions pertaining to the relationship, at the international level, of regulatory bodies. It is readily apparent, however, that where a Canadian bank has expanded its operations into the United States or some other jurisdiction, assessment of the health of that institution cannot accurately be achieved without complete and reliable information concerning the operations of the bank in the foreign jurisdiction. Vital information may frequently be in the hands of a foreign regulator. This was, in fact, true in the case of the CCB. It should be emphasized, however, that the bank's collapse was not due to the U.S. regulators' refusal to cooperate with the Canadian authorities. Rather, the OIGB's failure to respond adequately, and in sufficient time, to the U.S. reports it did receive, delayed the inevitable realization of the CCB's true state.

Additionally, the foreign regulator may, on the strength of the information it possesses, be inclined to order that corrective measures be taken by the subject bank. These corrective measures may, as was true in the cease and desist order issued to Westlands Bank, have material consequences for the bank's Canadian operations. Clearly, knowledge both as to the state of health of the bank's foreign operations, and the remedial options likely to be pursued by the foreign regulator, would assist Canadian bank regulators in their own program. With the rise in the scale of operations of the foreign-owned Schedule B banks, the mutuality of interest in bank examination in the U.S. and Canadian regulators which is a natural forerunner of a mutual interest in the exchange of information between these regulators, will come into being.

Recommendation 38

It is recommended that the executive branch of government or the regulator, as its delegate, endeavour to develop a system of reciprocal exchange of information between Canadian and foreign bank regulators, protecting, as may be necessary, the confidentiality of the exchanged information, so as to permit full assessment by the Canadian regulator of the financial condition of a foreign subsidiary, affiliate, or branch of a Canadian chartered bank.

F. BANK ASSISTANCE PROGRAMS

1. Introduction

Much of the detail of the discussion which follows will prove unnecessary if the Canadian banking system is to be confined to a relatively small number of full service, Schedule A banks and a limited number of Schedule B banks. On the other hand, if access by new banks is to be maintained on a reasonable basis so as to ensure a competitive banking service in the country, a more elaborate plan must be maintained within the statutory structure to meet liquidity and solvency crises. It is on the assumption that the present policies in this area will continue that bank assistance programs, as hereinafter proposed, are dealt with in some detail.

When liquidity problems drift into insolvency problems, the real test of the banking regulatory system begins. It is not necessarily helpful to the community simply to bring into play the bankruptcy processes under the *Winding-up Act*, or the *Bankruptcy Act* if it were applicable to banks. Where the failure of the bank could have a serious impact upon the community or upon the Canadian banking system at home or abroad, the bank must in the public interest be kept operating by a reorganization of its assets, liabilities, management, and ownership.

There must, in the language of Sir Lyman Duff spoken long ago in an insolvency proceeding, be a law which will "deal with the existing condition of insolvency in itself to enable arrangements to be made in view of the insolvent condition of the company under judicial authority which, otherwise, might not be valid prior to the initiation of proceedings in bankruptcy". There must be some way provided in law whereby a bank can be kept operating, despite insolvency, where it is in the interest of the country to do so. The *Companies' Creditors Arrangement Act*, which was enacted many years ago to permit a company to rearrange its relationship with its creditors, when in or faced with insolvency, does not apply to banks. The statute does, however, afford an interesting parallel which might well be followed in the statutory scheme for the regulation of banks in troubled circumstances. The Act was based upon an English statute, enacted in 1929, which provided for a judicially approved compromise or arrangement between the company and its creditors and/or between the company and its shareholders. The compromise or arrangement could be imposed whether or not the company in question was insolvent. There is no such legislation in Canada today, although in the past, we have had similar provisions in various corporate statutes such as s.134 of the now repealed *Canada Corporations Act, 1971*. It will be proposed shortly that a somewhat similar program be installed in the *CDIC Act*. In the result, the amended *Bank Act* and *CDIC Act* would be a self-contained code for the corporate administration of a bank from birth to death.

When the banking regulator is faced with serious troubles in a bank, there are three basic alternatives available. The most obvious and drastic is to seek authority to place the bank in liquidation. The second alternative is to assess the extent of the damage in the troubled bank, and determine whether a merger with a healthy (and probably larger) bank would be an appropriate solution. The third alternative, a rescue program, as established for CCB, may involve a restructuring or reorganization of the bank in one of a great variety of ways with a view to restoring it to financial health and retaining it in the banking community. That rescue operation may employ public or private funds, or a combination of both. In the statutory plan proposed by the Commission, the regulator would have the responsibility by statute to recommend which course of action is appropriate in the circumstance, and to seek the authority of the Minister of Finance to proceed. As the body in charge of supervision and inspection of the banks, the regulator would be the appropriate agency in which to place this responsibility. It will possess all the information flowing from the bank through the frequent contacts between the regulator and the bank and its external auditors. As the insurer, the new regulator will have additional sources

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provincial agencies consider them part of the information to be disclosed to the investors. In the United States, the federal securities regulators have moved gradually to review bank activities through regulation of the issuance of securities of bank holding companies to the prejudice of the traditional system of confidential supervision.

It is inherent in the position of the bank regulator under the aforementioned sections of the *Bank Act* that a conflict of interest arises upon the application by a bank for authority to publish a prospectus in connection with initial and secondary trading in bank securities. There is a desire on the part of the confidential supervisory body to maintain the confidence of the information accumulated or produced by the regulator in his supervisory role, and not to force disclosure of it through prospectuses supporting security sales. We have seen one instance where the prospectus as approved by the OIGB gave no indication that the bank had recently been classed as unsatisfactory by the regulator. These conflicts cannot be resolved in our present system where the same body, the banking supervisor, is responsible for both the confidential supervision of the banks and for the regulation at the federal level of documentation surrounding the sale of securities in the bank to the public. A second conflict arises between the provincial regulators of trading in securities and the managers of the confidential supervision of banks as to what must be revealed to the investing public concerning such matters as the regulator's reports on the bank. In the United States those conflicts are wholly between regulatory agencies at the federal level.

Where a bank is experiencing liquidity problems, or has a loan portfolio characterized by a significant element of unsatisfactory loans, it may be attractive to a regulator to permit the bank to attract additional resources through the issuance of shares or debentures. In addition, where the bank, for example, is the subject of an unsatisfactory report by the regulator, the regulator must decide whether the prospectus should be required to reveal such a fact. It has earlier been recommended that the federal regulator should be empowered in some circumstances to order that cease and refrain orders not be disclosed. Confidence in the banking system may be seriously eroded by disclosure requirements, including those which may be required by provincial authorities. It may be, and has been strenuously argued, that decisions as to the limits of disclosure must, in a constitutional sense, be exclusively within federal jurisdiction, otherwise effective and complete regulation of banking by federal authorities would not be possible. This Commission is not driven by its mandate to resolve such a weighty issue. This is compatible with the recommendation concerning disclosure of cease and refrain orders as discussed earlier in this chapter. The of information to feed into the decision-making process, and above all, it will be experienced in the liquidation process.

It is the intent and purpose of these recommendations concerning bank assistance programs that such programs shall be designed, instituted (subject to prior ministerial authority), and administered throughout by the regulator, subject to judicial intervention where holders of interests in the bank's capital claim compensation for any loss of rights or value suffered under the program. In order to efficiently facilitate the assistance program, a curator, or some like official, should remain in control of the bank as the agent of the regulator, with the authority in the regulator to perform such function, if warranted in the circumstances. Necessary capital funding would be provided or organized by the regulator who may take debt or equity securities, beneficially or on behalf of others. Finally, it is the overall purpose of these recommendations by the Commission to ensure that a bank designated under a bank assistance program does not fail, and is ultimately either returned to private ownership according to the then provisions of the *Bank Act*; or, where the Minister of Finance deems it appropriate, after having considered the recommendation of the regulator, merged with another existing and solvent bank. Where, in the course of a bank assistance program, circumstances make it appropriate in the opinion of the Minister of Finance acting on the recommendation of the regulator, a bank may be placed in liquidation, but in such circumstances, there should be compensation in full for any depositors and debt security holders of the bank, saving only those who have invested capital, as defined in the statute, in the bank.

Inherent in the program to be proposed are three characteristics: (a) provision would be made for the continuation of the operations of the bank, albeit under new senior management put in place by the CDIC, under arrangements which would assure the depositors that their funds were secure and would be repaid in the ordinary course of the bank's business; (b) if all outstanding debt and equity capital is to be cancelled, a nominal number of shares would be issued from treasury to the CDIC to preserve the continuance of a functioning corporation, all as approved by the Minister in the bank assistance program; and (c) any rights lost, surrendered, or cancelled which were theretofore held or enjoyed by capital investors would, if found to be of value, be compensated, such compensation (if any) to be determined by a superior court in the jurisdiction where the head office of the bank is situated. Any such compensation determined by the court to be payable would be paid by the regulator. All amendments to the *Bank Act* required to facilitate the implementation of the program are recommended.

Commission for the purposes of its task must assume that the authority resides in the federal Parliament to regulate exclusively banking in all its aspects including the offering and trading in bank securities.

These problems arising within the federal regulator's area of responsibility are soluble by the employment of experienced and qualified personnel in the office in question. Where such a person is confronted with a duty to scrutinize and approve prospectus material, and at the same time conduct the confidential supervision of the bank, the clashing interest will have to be reconciled by the regulator in the public interest. The Commission sees no alternative to this under the present state of our administrative structure, and indeed draws comfort from the fact that this kind of conflict arising elsewhere in our federal administrative jurisdiction is solved on this basis. Given that no federal securities agency exists in this country, the *Bank Act* must continue to govern bank securities issues to the extent necessary to protect the interests of the banking industry. The authority of the regulator should be expressly extended if necessary to protect the bank from disclosure which would expose the bank or the banking system to injury.

Recommendation 42

It is recommended that the Bank Act provisions regarding the issuance and trading of bank securities continue to place the authority to approve bank prospectuses in the regulator of banks; and that the regulator be empowered to protect a bank from disclosure of information and material associated with the bank supervisory and regulatory system, where necessary in the interests of the banking system as a whole.

H. MISCELLANEOUS

1. Role of the Regulator as Liquidator

Another issue arising in the administration of assistance to a troubled bank is the role of the CDIC as liquidator. Its Act presently authorizes the CDIC to act in that capacity. In practice, the CDIC has not done so, and in hearings before this Inquiry has taken the position that it should not do so in ordinary circumstances. There is, of course, an inherent conflict between the single agency acting as a liquidator and as a claimant against the assets of the insolvent bank by subrogation. The submission of the CDIC goes further and points out that the necessity for a public liquidator in some countries does not apply in this country where the tradition in commercial liquidation proceedings has developed a specialized division of the accounting profession, the

Continuity of the bank's operation is a condition precedent to all provisions made for this program in the statutory plan. The right of the investors of capital to compensation for the loss of their interests in the bank as a part of one of these programs would, for example, entitle the interest holder to his day in court to have his right to compensation determined and to have that compensation, if any, assessed; but that judicial process would proceed entirely outside the bank assistance program and would not interfere with the continuous operation of the bank.

2. Institutional Capability

One of the critical reasons for the failure of the CCB Support Program was the lack of statutory identification of an office or agency responsible for the decision whether to recommend to the Minister of Finance that the bank be liquidated or be saved. A second deficiency was the lack of an office or agency responsible for the coordination, design, implementation, monitoring, and revision, if necessary, of the Support Program, once a rescue operation had been determined by the Minister to be appropriate.

Under the Parliamentary system of government, and particularly the version thereof developed in this country, the executive branch, represented by the responsible Minister, ordinarily has the right to make such decisions as the grant of a licence or authority to operate a bank, or whether, at the other end of its life, the bank's existence should be terminated. However, under the present *CDIC Act*, the CDIC has the authority to institute proceedings to bring about the winding up of the bank if it is insolvent or about to become insolvent. The Wyman Committee for one has approved of this power in the CDIC, there are precedents outside our country, such as in the United States, where this administrative level of decision is indeed the basis of banking regulation. The *Winding-up Act*, as presently constituted, permits any creditor with a claim in excess of $1,000 to initiate winding-up proceedings of a bank. The Commission considers it more appropriate in the Canadian administrative pattern to leave the basic decision to rescue or to liquidate to the executive branch, that is to say the Minister. The responsibility in the administrator, the banking system regulator, is to make recommendations to the Minister as to which course should be followed in the circumstances. The authority to make the ultimate decision must, in this view, reside at the ministerial level. Consequently, s.29 and perhaps other provisions of the *CDIC Act*, and those provisions in the *Winding-up Act* already mentioned should be repealed, as these are inconsistent with the administrative program recommended herein, and indeed with the regime established under the *Bank Act*.

In short, the statutory plan proposed authorizes and directs the regulator to recommend to the Minister of Finance the liquidation, merger, or rescue of a bank with liquidity or solvency troubles. The decision of the Minister will set in motion the statutory machinery whereunder the regulator initiates and conducts the appropriate action. Where it is determined by the Minister that the bank should be assisted through its liquidity or solvency problems, the regulator should propose a comprehensive bank assistance program for ministerial approval. Where, in the view of the regulator, the bank is insolvent or faces immediate and inevitable insolvency, the regulator may (and no doubt in practice, invariably will) include in the recommended bank assistance program provision for the cancellation or reduction of the capital investors' interests as may be appropriate in the circumstances. The statute should, for the purpose of a bank assistance program, define capital as including all securities issued under the *Bank Act*, that is both share and debt securities. The Minister should only have authority to approve such a term in a bank assistance program where he finds that the bank is insolvent, or faces immediate and inevitable insolvency. Upon the approval of such a bank assistance program by the Minister, any cancellation or reduction of the interests of an investor in the bank's securities shall be deemed to have occurred, and the corporate status, the incorporating documentation, and financial statements shall be deemed to have been revised accordingly. A capital investor affected by such a provision of an assistance program may apply to the appropriate superior court for the determination of the solvency of the bank, and should the court determine the bank to be solvent (whatever conclusion the Minister and the regulator may have reached in adopting the bank assistance program), the court shall then assess the value of the loss of interest or rights suffered by the holder of an interest in the capital of the bank by reason of the bank assistance program. The compensation for such loss shall thereupon be paid to the capital investors by the regulator. The order of the court should be subject to a right of appeal by the holder of an interest in capital in the bank, or by the regulator, as the case may be, but the order of the Minister approving the bank assistance program should not be the subject of judicial review under s.28 of the *Federal Court Act* or otherwise, or be affected by any determination by the court in the valuation proceedings. A bank assistance program, where only liquidity problems have been encountered, would not be concerned with the cancellation of the interests of capital investors and all its consequences as above discussed.

In order to illustrate how the proposed program would function, it must be assumed that the first alternative of liquidation is rejected, and that a merger is not available or appropriate. In these circumstances, the regulator would recommend, under the existing provisions of the

Bank Act, that the Minister appoint a curator or some other like official to take over the management and direction of the bank on an interim basis. As part of the process, the regulator would then prepare a bank assistance program, taking into account the information then at hand. The program will form the basis of the recommendation to the Minister for the rescue of the bank. So far, this is much the same process on a more formal basis as that followed in CCB, except that the plan is designed by the agency in possession of all the information, and is a step outlined in the statutory program when other remedies are found to be inappropriate. The consequence of adoption by the Minister of a bank assistance program is tantamount to the determination by the FDIC under comparable legislation in the United States that the bank in question is an "essential bank". Once the bank assistance program is inaugurated, in order for it to succeed, it must most clearly bear the stamp of approval of the Government of Canada which, by the adoption of this plan, would signal to the investment community and the community at large, that this bank will not be allowed to fail, or at least will not fail at a cost to be paid by the depositors. Where this consequence is not desired by the executive branch of government, then merger or liquidation are the alternatives to be followed. The consequence of turning back from a failed program to save a bank is, in the practical political world, prompt compensation of necessity to all depositors and to those creditors whose interest is not embraced in the defined capital of the bank.

Recommendation 39

It is recommended that the CDIC, reconstituted as discussed earlier, be authorized and directed by revisions to its parent statute to design, implement and execute, all subject to the prior approval of the Minister of Finance, all bank assistance programs.

3. Elements of a Bank Assistance Program

The following is a more detailed description of the bank assistance program already sketched in outline. A bank assistance program must contain many elements, the most important of which is funding. This can be done by direct loans or by purchases of securities by the CDIC alone or in company with elements of the banking system if, in the circumstances, this is deemed to be appropriate and acceptable to those other elements including the banks, subject, except in the case of the CDIC, to ownership restrictions in the *Bank Act*. The regulator might, for the financial assistance of a bank, purchase unsatisfactory loans from the troubled bank as was purported to have been done on one interpretation of the CCB rescue contract; and as is regularly done by the FDIC in the United States. A funding measure common in the reorganization of corporate structure is the conversion of outstanding debt to equity. This cannot generally be practiced in the reorganization of banks because of the restrictions on ownership and concentration of ownership imposed by the *Bank Act*.

Another feature which has been found elsewhere to be vital for a successful bank assistance program is the partial or complete replacement of directors and management by the regulator. In some jurisdictions, this is a statutory power and indeed it has been recommended by the House of Commons Committee, and others appearing before this Commission, that this power be granted to the regulatory authority, however constituted. Where a rescue program is launched, the immediate aim is to restore public confidence so that the bank can attract deposits. The market, seeing the losses suffered by existing management, will, according to the evidence here, expect new management to be installed before new money is advanced to the bank. Whether the regulator should have such power outside an assistance program is debatable, and there being nothing in the record which indicates the need, such is not here recommended. It is the recommendation of this Commission that, where such action is required to be taken in a bank assistance program, it should be included in the program when authorized by the Minister.

The most difficult aspect of an assistance program in this, or any other jurisdiction similarly organized, is the question of the treatment properly to be accorded to those who have invested in capital (as defined in the revised statutory plan). By the OIGB guidelines, capital of a bank includes common and preference shares and long-term debt in the form of debentures. The *Bank Act* restricts the latter to subordinate unsecured obligations in the nature of a simple bond. All the components of a bank's capital, both debt and share capital, should be accorded equal treatment except as to priority in sharing any net worth in the bank as determined by the court, and the statutory plan should so provide. This is essential to the efficacy and fairness of such a program. Unless all capital is treated alike, one class could impede or block the rescue of a bank as it moves into a condition of insolvency, and force its liquidation, whatever may be the interest of the community in its continuance. This was the case in CCB, and it became necessary for governments to intervene and acquire the debt interest at the last minute.

It is important to note that in this chapter, the terms "investors' interest in the capital" or "the capital of the bank" refer to and include both share and debt capital. It has already been mentioned that the statutory plan for bank assistance programs should so provide. Consideration should be given to including in the statutory plan a requirement that instruments of debt capital should include a reference to the status of such debt in a bank assistance program.

The holder of each unit or element in the bank's capital should be entitled to institute the judicial process already described in the event such interest holder contends that, at the time of the adoption of the bank assistance program, the unit or element of capital held by the claimant had some value by reason of the fact that the bank was, at that moment, not insolvent. The court, by the statutory pattern, would be required to value such elements of capital, other than common and preference shares, in priority to share capital so that any value in the capital account of the bank at the date in question would be applied by the court first to the compensation of capital holders other than shareholders, and any residue shall then be applied to the preference, and finally, to the common shares, all in a priority analogous to a liquidation proceeding.

Where it is deemed by the regulator and the appropriate political authority that a bank rescue program should be inaugurated, it will, almost without exception, be done in circumstances where the bank is either insolvent or insolvency is imminent and inevitable. That being the case the banks' capital will, by definition, have been exhausted. Therefore, it would be inappropriate, if not fiscally immoral, to call upon the taxpayer or the shareholders of competitor banks to advance money to restore financial health to the ailing bank, all to the benefit of the investors in that bank who have, at this stage of affairs, ceased to have an existing financial interest in the bank. Their investment gamble has been lost.

In the United Kingdom and the United States, recent bank rehabilitation programs have been accompanied by a simultaneous acquisition by the regulator of the shares of the troubled bank or an agreement whereby the regulator will succeed to those shares, either absolutely or conditionally upon a continued decline in the affairs of the bank. It is essential, in order to treat equitably all contributors to the rescue, be they state or private, that the interests, if any, of capital investors be settled at the outset. Because of the sometimes enormous difficulties in getting agreement on such a matter, the Commission proposes that where the rights of any such investors are affected by a proposed bank assistance program, the statutory scheme should provide for the determination of the value, if any, by a judicial process of any such interests which have been cancelled or reduced by the provisions of the bank assistance program. If the regulator can demonstrate actual insolvency or imminent and inevitable insolvency, that is, that all capital of the bank has been, or is about to be dissipated, the court would make no award. However, should the court's assessment of the solvency of the bank differ from that of the Minister and the regulator, the court would then value the cancelled or reduced investors' interest. In this circumstance, the court might well, depending on the precise terms of the statute, find that the investor's loss included the loss of the right to continue as a shareholder in a solvent bank, and value the shareholder's losses accordingly.

Great difficulty was encountered in the case of CCB, and has been encountered in other countries with like regulatory systems, in determining precisely if and when a bank has become insolvent. The basic test, of course, is to determine whether the bank has any net worth in the sense that assets exceed liabilities in value. When the liabilities equal the assets there is, of course, no capital remaining in the bank, and the bank is insolvent. In order to determine whether the equation in any particular bank has produced insolvency, it is fundamental to determine the value of the loan portfolio because that is the principal asset of a bank. This entails assessing the worth of loans one by one to determine the value of the covenant of the borrower and the collateral security held by the bank. Such a route is hazardous, expensive, slow, and highly undesirable. What is required is some objective yardstick which might be easily and fairly administered as a summary technique in the determination of solvency or insolvency in a bank. One such yardstick might be the ratio of liquidity advances taken in by the bank in replacement of withdrawn deposits to the debt and equity capital of the bank. Where that ratio exceeds a range of 10 or 12 to 1 it is difficult to seriously argue that the bank is solvent, or if so, will remain in that condition very long.

There may well be other and better summary tests to determine, at least on a *prima facie* basis, the solvency or insolvency of a bank. The statute should, if possible, contain such a summary route. Otherwise the parties wishing to assert a residual value in their capital interest at the time of the adoption of the bank assistance program will be thrown back on the expensive process of valuing the loan portfolio by a detailed judicial examination. If the court finds the bank to be insolvent, this long and expensive asset valuation process will no longer be required, but failing that, a claimant for compensation will be faced with an expensive process.

No doubt the authors of a bank assistance program will on occasion consider that circumstances warrant the inclusion of an opportunity for the old capital investors to invest in new shares from the bank's treasury on the same financial basis as proposed for the public agency under the plan.

It will be noted that the proposed statutory process does not contemplate a shareholders' meeting or, if there be debt capital, a bondholders' meeting, for approval of the bank assistance program. The process requires the formulation of the plan by the regulator, approval by the Minister (who thereby determines the continuance of the bank as essential in the public interest), and the determination by the Court of the value, if any, in the capital interests which are to be cancelled by the plan. It would be a meaningless procedure, if not a charade, to require the capital investors to confirm their own execution. Parallels exist elsewhere in the law. Under present and past federal company legislation, provincial statutes, and legislation in the United Kingdom, an offeror, who in a take-over bid has acquired not less than 90 per cent of the shares of a company by class, may, by judicial process, obtain the remaining outstanding shares in such class upon payment therefor of the fair value of the shares as determined by a court if not settled by the parties. Another parallel is found in the *Canada Business Corporations Act* (and in provincial statutes, and in some states in the United States) where a dissenting shareholder may call upon the corporation in certain circumstances, such as on the adoption of a proposal for the sale of all corporate assets, to purchase his shares. The fair value payable for these shares by the company remains once again to be determined by judicial process failing settlement by the parties.

Liquidity support may be required by a bank on a short or long-term basis, the need in the former case having been occasioned by a momentary lapse in the matching of maturing obligations with liquid assets to meet them. Sometimes, as in the case of CCB and Northland, the requirement for liquidity support may be longstanding. The present statute provides that these advances may be made by the Bank of Canada as the lender of last resort. The Bank of Canada has the funds adequate for such extensive operations, and it is appropriate that this continue to be the source of liquidity financing in bank assistance programs. The awkward position of the Bank of Canada has elsewhere been discussed. It has the obligation as lender of last resort and it has a statutory obligation to take security for its advances. It does not have the apparatus to determine the extent of the value of the assets being taken in security. This value is known to the regulator, at least in theory, but not to the Bank of Canada. Therefore, as a matter of mechanics, the Commission recommends that (a) short-term liquidity needs arising outside a bank assistance program should be met as under the present law by advances from the Bank of Canada; and (b) when made under a bank assistance program, they should be made by way of requisition on the Bank of Canada by the CDIC as part of the bank assistance program, and that ministerial authorization should be required so that limits to these liquidity advances can be established and varied from time to time. The responsibility of the Bank of Canada under this procedure would be limited to complying with requisitions from the regulator who would be responsible for appropriate security being made available to the Bank of Canada.

Other funding required in the restoration of the financial health of a bank would be raised and administered by the CDIC through loans from the Government of Canada, other banks and other sources as circumstances may require or permit. Variations of such programs might be conceived, such as the purchase by CDIC of troubled loans from the bank in consideration for the assumption by the CDIC of appropriate amounts of the bank's indebtedness to the Bank of Canada for liquidity advances. The CDIC in turn would make an arrangement with the Bank of Canada for a fixed term for retirement of the debt so assumed by CDIC. This, in effect, creates an immediate pool of funds available to the regulator directing a bank assistance program.

It may be necessary, as has been found in both the United Kingdom and the United States, and as is evident from the CCB rescue story, to refocus a bank assistance program in mid-stream. With the additional information flowing into the regulator from a curator in possession and new management in office, the comprehension in the regulator of the nature and extent of the banking difficulties may frequently be quite different from the earlier apprehension. The scale and nature of the remedies to be prescribed may need variation or redesign if the bank is to be restored to health. This may require ministerial approval if further exposure of public funds is entailed or if the terms upon which public funds are placed in the troubled bank are significantly varied. Again the burden of revising the program and of seeking further ministerial approval would fall upon the regulator. Midway course corrections have been required in recovery programs in other countries recently and indeed might well have been considered in the case of CCB. Provision for this capability should be made in the statutory plan.

Once the executive branch or its agencies have launched a bank assistance program, its success depends to a large measure on the atmosphere created in the banking community by that process itself. Where, for example, it is perceived by the financial institutions in the marketplace to be an inadequate proposal, or otherwise unlikely to achieve success, the program is doomed almost before its launch. One difficulty encountered in the CCB experience was that immediately after the announcement of the rescue program, the House of Commons Standing Committee on Finance, Trade and Economic Affairs commenced hearings into matters surrounding the rescue program and the collapse of the bank. The program itself started on 25 March 1985 and the House of Commons Committee sessions commenced in early April 1985 and continued until the report of the Committee in June. The program came to an end with the liquidation of the bank on 1 September. Hearings of the Committee inevitably attracted considerable coverage by print and broadcast journalists and undoubtedly damaged the chances of success of the rescue program. Such is the evidence before this Inquiry. The legislative branch of course must operate in the discharge of its role under the Constitution without hindrance or interference, including other branches of government. Functional overlap and interference, on occasion, are inevitable. However, the evidence assembled by this Commission calls for the observation that the legislature, under the leadership of the government, should exercise considerable caution in conducting public discussion of a bank assistance program during its operation. Banking, as has been seen elsewhere in this report, is a subtle mixture of reality and perception. Critical examination of a bank in the daily press is hostile to the success of a program whose principal objective is to restore confidence in the bank in the financial markets and in the public generally. A hearing of any kind is a magnet to the media. Democracy can only thrive by the exchange of information. It would be constructive if some process could be designed so that this exchange could proceed later when the patient can better survive the treatment. If the bank assistance program is institutionalized in the statute, of course, the need for Parliamentary Committee review may disappear.

One extreme consequence of a bank assistance program is that which befell the CCB bailout. Liquidation there became inevitable and, with ministerial authority, the CDIC made application for the appointment of a liquidator. It must be recognized that not all rescue programs succeed. This was seen in the case of CCB. Nothing in the field of financial restructuring, particularly in banking, can be a guaranteed success. As already mentioned, however, where the bank assistance program is terminated by an application for liquidation, then the statute may well provide that those depositors and lenders of moneys not within the definition of bank capital, as established in the statute, should be compensated for their dealings with the bank. In both Canada and the United States, public reliance on the prospects of success of a bank rehabilitation program has led to full compensation of loss by depositors. This is both fair and, probably, politically inevitable, but it also should be said that such a practice would sap the strength of self-discipline in the system if it were to lead to universal compensation on an institutionalized basis. The establishment of a bank assistance program, however, would seem to be at least one instance where failure of a bank should bring compensation for loss to depositors.

Ordinarily a bank assistance program would be terminated when the presence of a curator on the premises of the bank is no longer required and where the bank has retired its obligations incurred in the course of the assistance program. Where the bank has recovered by reason of the program to the extent that the regulator, with ministerial authority, determines that the bank can be returned to general ownership in the community, the bank assistance program may be terminated or replaced by other fixed arrangements with the regulator, and the regulator, with prior ministerial approval, would then proceed to dispose of its stock and/or its debt securities in the bank. The buyers, of course, must be those qualified under the *Bank Act* to hold shares. The manner of disposition may vary in the circumstances, from public offering on the one hand to a merger on the other, all subject to ministerial approval. If everything proceeds according to plan, the public investment would be recovered, and the community would have been spared the loss of a bank. This is a general outline of the statutory structure herein recommended for the preservation of the integrity of the banking system as a whole.

There are many related issues which spring up around a bank assistance program. For example, the statute should contain a definition of insolvency. No comprehensive definition is contained in the *Bank Act* although s.276 provides that suspension for 90 days by a bank of payment of its liabilities as they become due constitutes the bank insolvent. The *Bankruptcy Act* defines insolvency both in terms of an inability to meet obligations as they generally become due and as negative net worth. Under s.3(1) of the *Winding-up Act*, insolvency depends, among other things, on the company's inability to pay its debts as they become due. It would be of assistance to the community if the *Bank Act* definition of insolvency could be coordinated with that found in the *Bankruptcy Act* and the *Winding-up Act*. However, because liquidity support payments will always enable a bank to meet its obligations as they become due, any test which focuses on an inability to pay liabilities when due is, at base, unhelpful in defining bank insolvency. It is the view of the Commission that the definition of insolvency should be the simple and traditional definition in most bankruptcy legislation, namely, that liabilities have come to exceed assets. An alternative is to retain the inferred definition in s.278(2) of the *Bank Act* by simply adding thereto the proposition that, in determining whether the bank can meet its liabilities as they fall due, funds supplied by way of liquidity advances from the Bank of Canada shall not be taken into account as having retired the liability in question. This is superficially attractive but would lay any bank open to the possibility of proceedings in liquidation where some very short-term and very small liquidity support is required. Any difficulties which flow from the application of the simple definition of insolvency as mentioned may be overcome in the context of a bank assistance program and its ancillary judicial process by a deeming provision, as already discussed.

The *Bank Act* must, of course, be revised to permit the CDIC to own or control, as part of a bank assistance program, all or any part of the outstanding shares and, for greater certainty, debt capital of a bank. In the CCB bailout program, the major banks were involved financially and received warrants to acquire shares of CCB in the future. In other jurisdictions, banks have been involved in financial participation in a rescue without ultimate or immediate reward in the form of shares or the right to acquire shares in the rescued bank. It is inappropriate, in the view of the Commission, to grant, directly or indirectly, permanently or transitionally, to competitor banks equity in the bank which is the subject of the program. In the CCB program, the warrants initially were to be issued to the CDIC. The major banks shared in this aspect of the program when they subsequently joined it. In the view of the Commission, the consideration, in the legal sense of the term, for the participation of other banks in a rescue program is their vital interest in the integrity of the banking system upon which they depend for their existence. Their reward is recovery of their advances, but far more important is the restoration of public confidence in the national banking system of which they form a part. They will directly benefit in that most important way, and that is sufficient.

Recommendation 40

It is recommended that the statutory structure authorizing the implementation of bank assistance programs should provide;

(a) for the cancellation or reduction of any interest in the capital of the bank as defined in the statute with compensation if applicable;

(b) for the replacement of members of the board of directors and management of the bank;

(c) for liquidity advances to be provided by the Bank of Canada, and other funding appropriate to the program by public agencies and the banking system as appropriate in the circumstances; and

(d) for the interim modification of, and adjustment to, the bank assistance program in the course of its implementation.

Recommendation 41

It is recommended that the legislation supporting the bank assistance program concept should also provide:

(a) for liquidity advances to be provided to the bank by the Bank of Canada on the requisition of the regulator, all subject to prior ministerial approval, with security for such advances to be arranged by the regulator and posted by the bank with the Bank of Canada;

(b) for the temporary ownership by the regulator of share and debt securities in the bank during the operation of the bank assistance program;

(c) for a judicial process for the determination of any claim for compensation by the holder of an interest in the capital of the bank, as defined for these purposes by the statute. The procedure should include a statutory presumption to facilitate the disposition of the preliminary issue of the solvency of the bank; and

(d) for the ultimate disposition of the bank on termination of the bank assistance program.

G. SECURITIES REGULATION AND DISCLOSURE

Sections 145 to 154 of the *Bank Act* constitute a code of directives to the financial community and the bank regulator concerning issuance of and trading in bank securities. These sections represent federal involvement in the securities exchange field otherwise almost exclusively occupied by the provinces. None of the federal agencies testifying or making submissions at the Inquiry proposed a withdrawal by the federal authority from bank securities regulation. The provinces of Quebec and Ontario, on the other hand, have showed varying degrees of aggressiveness towards the regulation of trading in bank securities. The basic question presented to this Commission concerns provincial requirements of full disclosure of financial and management matters relating to banks through prospectuses and other releases. The requirement of disclosure under provincial securities laws may prejudice the federal confidential supervisory system. For example, the reports made by the federal regulator are made confidential by s.251 of the *Bank Act*. The auditor-liquidator, auditor-receiver, or auditor-trustee. It is the view of the CDIC that this practice should be followed, and indeed it was followed in the case of both CCB and Northland, and the Commission concurs in this conclusion.

2. Liquidity Advances

Until the regulator with ministerial authority implements a bank assistance program, the responsibility as a lender of last resort for liquidity funds should continue to be in the Bank of Canada. Limits may be required to ensure participation by the regulator in the process at an early stage in order to anticipate the need for a more formal assistance program and to protect the Bank of Canada's interest by the progressive taking of adequate security.

At the present time, as we have already seen, the fact and the amount of liquidity advances are published with reasonable promptness in the Canada Gazette. There are two immediate problems arising out of the manner in which liquidity support is provided under the present system. First, the Bank of Canada takes prior security against all comers, thus discouraging other depositors from coming forward and placing their funds in the bank recoverable in liquidation only after the claim of the central bank. Second, the fact that liquidity advances are publicized at least unsettles the investing public's view of the bank, and may precipitate, as it has in the past precipitated, a run by depositors away from the bank. All these developments of course occur at the time when deposits are most needed. These facts also inhibit other banks from providing liquidity support at the very time when the troubled bank may wish to take advantage of this private source of assistance so as to avoid the mandatory publication which follows the receipt of Bank of Canada funds.

The nature of a liquidity advance is to enable a bank to remain in business when it is unable to pay its indebtedness as it matures despite the fact that its assets may exceed its liabilities by a wide margin. The reason such advances are necessary is inherent in the nature of the banking business, which, unlike most other commercial activities, is acutely sensitive to loss of confidence by the investing or money-lending public. Knowledge, or even suspicion of illiquidity, frequently, if not invariably, triggers a "flight to quality" in which depositors, whether professional money managers or members of the public, simply pull their money out of the bank and go to what are seen as safer depositories. The result may be a "contagion" of nonconfidence and a run in which the bank loses much of its deposit base. The bank moves into a condition of extreme illiquidity, and would collapse in a state of apparent insolvency but for support by the central bank or other lenders who come in and replace the departing depositors. Here, the line between loss of liquidity and insolvency becomes, because of the run phenomenon, very thin and indistinct.

Where liquidity support is given to solve acute liquidity problems, such as those which prompted the CCB Support Program, it is obviously counter-productive to require publication of central bank liquidity advances. Such publication merely makes it known in the financial community that the bank is in straitened circumstances and exacerbates the contagion effect. It is curious to note that this phenomenon has been clearly recognized by those who drafted the *Bank Act*. In s.175(4), and in the proposed new s.313.1(5), ministerial directives relating to the sensitive matters of capital adequacy and the existence of imprudent or improper banking practices are exempted from legislation which would otherwise require them to be made available to the public upon request. There is an odd conflict in philosophy which permits secret regulation of some matters vital to the bank's success and stability, yet requires publication in great detail of other matters which are equally sensitive.

The publication requirements currently embodied in the *Bank Act* have, despite their inherent dangers to the stability of banks receiving liquidity support, been justified as the right of the community to know how public funds are being used and, in particular, that public funds have been placed in a commercial enterprise as unstable as a bank in trouble. It is notable, however, that the Crown puts money into a great many commercial enterprises, and little or no notice is given. It has also been said, by way of explanation, that potential investors and depositors should be made aware of the nature of the institution into which they are placing their funds. This can hardly be a valid explanation, however, when no such requirement is established in the statutes at the present time where those same liquidity funds for the same purposes come from the other chartered banks. The principal statutory requirement relating to disclosure of such investments should be an annual report by the recipient of the payments, and some reference in the annual public accounts. Similarly, publication of the Bank of Canada's annual statements will reveal the amount at that date of liquidity advances to banks in general. Publication of the recipient bank's annual audited financial statements would also reveal amounts advanced to the bank at the date of the statement. It should, in the Commission's view, be a matter for the regulator to settle by an appropriate general guideline or a specific order whether liquidity advances should be specifically identified in a recipient bank's year end statements.

Recommendation 43

It is recommended that the present statutory provision requiring publication of liquidity advances by the Bank of Canada be repealed, and that publication of liquidity advances be limited to the annual financial statements of the Bank of Canada which shall report all such advances to the banks in total, and to the annual financial statements of each recipient bank. In each case the financial statements shall report liquidity advances outstanding at the end of each month in the course of the fiscal year, provided that there be appropriate amendments to all applicable federal legislation so as to authorize the regulator on the application of a bank to suspend all or part of the obligation in a bank to so publish receipt of liquidity advances by the bank for a period not exceeding twelve months.

Under ss. 173(1)(p) and 277(2) of the *Bank Act*, short-term lenders of liquidity funds who take security for such loans are entitled to first priority in the event of the recipient bank's insolvency. Although nothing in the *Bank Act* or in the *Bank of Canada Act* explicitly so provides, the Bank of Canada in practice invariably ranks as the first such secured creditor. In part this is due to the fact that under s.19 of its Act, the Bank of Canada is required to take security for all moneys it advances, whereas other banks need not, and indeed do not, do so in many cases. This probably also flows in part from the Bank of Canada's lending practices.

There are two possible alternatives to the system whereby the Bank of Canada inevitably possesses a prior charge in respect of its liquidity advances. First, the statute could provide for the joint or equal ranking of all providers of liquidity support, whether the provider is the Bank of Canada or any other chartered bank. Secondly, the statute could give the Bank of Canada power to assign its priority to a chartered bank which undertakes to make the required liquidity advances to another bank. No suggestion that the positions of the Bank of Canada and other lenders be equalized by prohibiting the taking of security by the central bank can be adopted, for the reasons given in the submissions of the Minister of Finance and the Bank of Canada. Public funds advanced to commercial undertakings should be secured. Liquidity advances must be made available quickly, and the central bank would be less willing to make the necessary advances of public funds if these were not appropriately secured. The purpose of liquidity advances is to enable the bank to continue to operate and to regain investor confidence. The conflict without answer arises because the Bank of Canada's prior security for liquidity advances or deposits frightens off the much needed money market depositors who are then aware that on a liquidation there would be few assets to settle their claims. The bait frightens off the quarry.

The availability of liquidity funding from sources other than the Bank of Canada is neither inherently harmful nor undesirable. The banks are free to take security for such advances. The practice of mutual support among the chartered banks is valuable and ought to be encouraged.

Recommendation 44

It is recommended that no change be made in the Bank Act provisions for the taking of security for advances by the Bank of Canada to a bank.

3. Deposit Insurance Coverage

Related to the problems on insolvency, real or impending, is the quantum of deposit insurance coverage under the *CDIC Act* (presently $60,000). Although the structure and funding of the deposit insurance scheme presently prescribed by the *CDIC Act* would appear to fall outside the Commission's mandate, this topic was extensively addressed in counsels' submissions in the course of the hearings.

The existence of insurance is regarded in the commercial community as an essential back-up for the well-being of a business. However, the extent of available coverage is limited by the insurer's need to minimize loss, and sometimes deductible amounts are incorporated so as to simplify administration and prevent abuse. These would not appear to be indicated as essential features of a bank deposit insurance scheme. Rather, what may be essential to such a scheme is a limit on coverage so as to retain the discipline of the market-place and the investment business. Limitations on insurable amounts have been proposed and implemented in order to create an incentive in the user or beneficiary of the system to look after his or her assets in a proper and prudent manner. The limit under the *FDIC Act* in the United States is $100,000(U.S.). In the absence of such limits, the direct relationship between institutional risk and rate of return would encourage the user to place funds in the least stable institutions, thereby creating the greatest potential for loss to the insurer. Such a policy when applied to an employee funds manager would reverse his duty under the laws of negligence. Where he formerly was under duty to minimize his employer's risk of loss, he must now make his investment decision so as to maximize the return to the employer, the risk of loss having been removed.

The Wyman Committee concluded that market discipline would be further increased by the introduction of depositor co-insurance from the first dollar. The House of Commons Standing Committee recommended against any co-insurance. The Royal Bank has submitted that a graduated coverage system, by which 100 per cent of the first $20,000, and thereafter, 75 per cent of only the next $50,000 would be insured, should be adopted.

Assuming for the purpose of dealing with submissions made to this Commission on the subject that these questions are within the Commission's mandate, it is recommended that a limit on the insurable amount such as the present limit of $60,000 should be maintained for the reasons already outlined. This limit would appear to be adequate to cover the average consumer's deposits which must be the essential purpose for the insurance scheme in the first place. The ceiling of $60,000 was only recently established and the Commission has heard no evidence which would indicate the circumstances have changed since that time.

It is convenient to discuss in association with deposit insurance generally the proposal made by the Royal Bank and others that each identifiable group of deposit-taking institutions who come under the insurance plan of the CDIC should be grouped into a pool so that a rate for premiums payable by members of that pool can be struck so as to reflect the loss experience of those members. The analogy is the typical workers' compensation statute in the provinces.

Recommendation 45

It is recommended that the statutory authority, the CDIC, consult with the appropriate insurance authorities on the proposition that premiums should correspond to the cost of each class of risk insured and that if the CDIC considers, on the basis of the advice taken, that the proposal can be instituted to the profit of the community at large, appropriate regulations should be issued by the CDIC.

4. Direct Rights of Action Against a Bank and Others

Mention has been made of the enforcement by CDIC of its subrogated rights arising in its role of insurer. No change to the present statutory provisions is necessary. No broad power is granted to the insurer in the *CDIC Act* to enforce directly duties owed to the bank by its directors, officers, auditors, or others. This situation may be contrasted with the position of the FDIC which in addition to its subrogation rights as insurer is, under 12 U.S.C., ss.1821(c) and (d), required to act as liquidator of a failed bank and to enforce "the individual liability of the stockholders and directors thereof." The record reveals that the FDIC has instituted many such suits in the past, and has many presently outstanding.

Apart from claims by a bank in its own name for recovery of losses suffered by the bank, there are claims which may arise directly in the investor in bank securities. The investor may make such a claim against the bank, the underwriters, the auditors, directors, officers, legal advisers, and perhaps others somehow connected to the process of issuance of, or trading in, securities. Such a claim may procedurally evolve into a class action. Another alternative procedure may be through a statutory nominal plaintiff who would make a claim on behalf of the investors. The Commission received information from small-scale investors in these two banks who lost their entire investment which had, in some cases, been made in these banks after assurances to the public about the condition of these banks. Independent action by small investors is expensive and likely uneconomic. What is considered to be required now is an efficacious procedure for the enforcement of the rights of depositors and shareholders which now exist and which would be created under recommendations hereinbefore made.

The class action is in theory a solution, but by reason of the uneven nature of that procedure across the provinces, it is generally considered ineffective. Class actions are difficult to organize and to prosecute. This type of action has proved unsatisfactory in the United States. Consideration should therefore be given to the advisability of including in the legislation provisions, devices or processes designed to render more economical the assertion of rights in this field. Procedures in the *Canada Business Corporations Act*, some comparable provincial statutes, and the *Ontario Securities Act* and other statutes governing provincial securities regulatory bodies, embody the concept of suit by a public official as nominal plaintiff in the circumstances permitted by the various statutes. In some statutes, such as the *Canada Business Corporations Act*, the public authority has standing to sue under various sections. In others, such as the Ontario *Securities Act*, s.132, the Commission may only sue in limited circumstances, and even then, must be authorized to do so by a Superior Court judge.

It should be added that claims arising in the bank itself against all the persons mentioned above require no special treatment in banking legislation. These are direct causes of action, and may be enforced by the bank or derivatively by others in civil actions in the civil courts.

The following recommendation is made by the Commission in the realization that a balance must be maintained between the right of the public to protection and its co-existing interest in being served by willing and qualified persons in the role of director, manager, auditor, and perhaps other roles as well. Directors for example are mainly part-time. They are in a different relationship in their role from that of auditors, underwriters, and officers. The duties and risks of board members should not be made so onerous or civil action so easily available that suitable and responsible individuals may refuse to serve due to the risk of exposure to expensive, lengthy, and perhaps unfounded, but nevertheless expensive litigation.

All this reduces itself to the final consideration of the appropriate nominal plaintiff. The regulator is ineligible because of the possibility that a claim asserted by an investor or depositor may run against the regulator, alone or in association with others. The liquidator may be appropriate to the role if the bank is, in fact, in liquidation at the time, however the investors' claims may well arise before the advent of liquidation. This process of elimination leads one to currently established public officials. Perhaps the most appropriate from amongst that group is the Director under the *Canada Business Corporations Act* already mentioned.

No attempt is made to draw up a catalogue of all potentially eligible defendants in actions for the enforcement of the several rights and duties which have been discussed. All this will be determined by the plaintiff however the action is structured, and the cast of defendants will vary with the circumstances in each case.

Recommendation 46

It is recommended that a statutory scheme be established to enable the enforcement of the rights against directors of banks recommended under Recommendation 14, and other claims related to the operation of banks and the trading in bank securities, including direct causes of action by investors in those securities. These claims should be enforceable by action brought on behalf of and for the benefit of the holders of those rights and claims, by a nominal plaintiff appointed by statute such as the Director, appointed under the Canada Business Corporations Act, or other appropriate public official.

Nothing herein contained is intended as a proposal to impede the enforcement process for long existing rights of the bank and its shareholders against directors and others where such action may presently be taken.

Chapter 7

CONCLUSION

The Commission has examined the operations of the banks, CCB and Northland, from their inception until the decision to put them into liquidation. This report deals with those operations and the causes of their collapse. From these events, conclusions have been drawn and recommendations made. Throughout it has been made clear that all which is contained in this report found its source in the evidence of the history of these two small banks. This has not been a general review of Canada's banking institutions. Such would be entirely outside the Inquiry mandate.

The Commission enjoyed the happy experience of receiving testimony from a great number of persons in banking and related businesses, both public and private, who brought considerable talent to their task. These witnesses spoke with candour and complete frankness, including some in the public service who might have been considered to be under the intense scrutiny or curiosity of the press. Underlying the findings and recommendations in this report is a recognition that these troubles arose, not by reason of inherent lack of required qualities in the administrators and in the participants in the system, but rather, in the inadequacies of the structure of the supervisory establishment. It should also be recorded that the Commission was not denied access to any documents or records or witnesses, public or private, throughout this entire investigation. This cooperation made it possible to thoroughly examine all these agencies and banks and their voluminous records in a short space of time.

There has been nothing revealed in all these proceedings to indicate the immediate need to conduct a similar study in depth into the business operations of Canadian banks generally. Nothing has been uncovered which shows a systemic weakness requiring any such investigation. From all that has been studied here, the Canadian banking system is sound, well led, and is recognized outside this country as standing in the front ranks of world banking. A loss of one per cent of its operating entities has not occasioned alarm abroad, and should not cause Canadians to lose confidence in their banking industry.

What does come through in this study is the need to continue the studies going on elsewhere in the government of the financial business and its institutions, of which banking is a part. This scene is changing rapidly here and abroad. Communications have led world financing, its pressures, shifts and changes, to everyone's doorstep on a daily, even hourly, basis. What was clearly banking or insurance or trust business or factoring or discounting or underwriting, and so on, is now not so easily defined and marked off. The significant integration in recent years may well continue and will have a large impact on the form and substance of the bank regulatory institution. This presents a number of challenges to national regulation. In a federally organized community such as Canada, the scope and scale of these activities raise questions of constitutional authority and inter-plenary cooperation. When the *Bank Act* is again reopened, it will no doubt be opportune to attempt a definition of functions, a realignment of institutions, and the adoption of an interfunctional set of rules. Perhaps the same operations should everywhere come under the same supervision and regulation. All this is evident all along the fringe of the journey this Inquiry has taken. The recommendations deal with the core area of the Commission's mandate, and this observation is volunteered, simply in the hope that it may assist in the evolving reviews elsewhere underway.

The loss of these two banks was regionally a serious development of considerable impact. Losses have been suffered by many. Enterprise, however, goes on and new institutions and organizations will continue to emerge. The overriding impression from a national point of view is that banking is still a business in which Canadians excel, and the national system as a whole still ranks with the leaders on the world scene.

Appendix A

Evolution of the Canadian Banking System Since Confederation

The first Canadian banks commenced business long before Confederation, and early nineteenth-century bank charters embodied features of banking which are still current. These charters were based on, and influenced by, early grants of power to banks in the United States. The early practice of banking in Canada reflected, as well, a British heritage. The British valued bank stability over experimentation, and the Colonial Office maintained close control on early practices in British North America.

In the United States, a bank charter was granted by Alexander Hamilton, first Secretary of the Treasury, to the First Bank of the United States in 1791. It has been noted that the Canadian banking system is a direct descendant of the First Bank, which was in part modelled after the Bank of England. The First Bank had centralized financial power over currency and credit and, to some extent, over fiscal policy. It also performed functions as a lender of last resort to state banks. Another of the First Bank's distinctive features was its branch system which enabled it to extend its control and influence throughout the country. It was therefore in a position to encourage conservative banking policies and practices. The First Bank's success as a stabilizing central element of the industry as a whole significantly influenced early Canadian bankers and the eventual course of Canadian banking.

The banking principles of strength and stability evident in the First Bank's structure and practices were to wane in the United States with that bank's failure to secure renewal of its charter. The Second Bank of the United States, established in 1816, and organized along the same lines as the First Bank, also failed to survive beyond its initial 20-year charter. The principles behind these early American experiments thrived in the different Canadian environment, however. In the United States, distrust of centralization of power, and dislike by western agrarians of conservative, eastern banking practices, were sufficiently strong to close the First and Second Banks and to dictate the creation of a decentralized, unit banking system in the 1860s. National branch banking has until recently been impossible in the United States as a result of the combined existence of the commerce clause of the American Constitution which confers jurisdiction over interstate commerce to Congress, and political expediency which has prevented federal legislators from giving national banks more extensive branching privileges in their home states than state banks.

In Upper Canada, on the other hand, unit banking similar to that adopted in the United States had a short life under the *Act to Establish Freedom of Banking* of 1850. Under this Act, small banks were favoured, and each bank was to conduct business in one location. This development was opposed both by the now powerful chartered banks and by the British authorities, and it was ultimately unsuccessful in transforming the Canadian banking system into something along the lines of its American counterpart. In 1854, banking legislation moved further in the direction of a general Bank Act and the establishment of the chartered banking system. The number of chartered banks in Upper Canada rose dramatically in the prosperous 1850s.

Conservative elements in finance in Canada were generally much stronger than those in the United States, and distrust of concentration of power was weaker. The centralization of power appealed to Canada's nation-builders as well for both political and geographic reasons. Western Canadian interests did not possess sufficient strength to challenge the centralized structure of Canadian banking until after it was well entrenched. Finally, the Canadian banking system grew under English tutelage, undisturbed by major disruptions such as those caused to the American system by the Civil War and the controversy over paper money. All these factors combined to ensure that by the time of Confederation, the groundwork for a strong, conservative, national branch banking structure was well established.

The *Constitution Act, 1867*, conferred on the federal government the exclusive right to legislate with respect to "Banking, Incorporation of Banks, and the Issue of Paper Money", "Currency and Coinage", "Savings Banks", "Bills of Exchange and Promissory Notes" and "Legal Tender". Temporary legislation passed in the session of 1867-68 and supplemented by further enactments in 1869 and 1870 provided the initial post-confederation framework for the continued operation of the banking system which had previously developed in the confederated colonies. *An Act relating to Banks and Banking* was passed in 1871. This general banking legislation, since re-enacted with amendments approximately every ten years, has provided the continuing framework for banking in Canada.

Banks from the earliest statutes were required to keep a minimum of one-third of their cash reserves in the form of Dominion notes, and were subject to certain other restrictions on bank-note issue in the interests of stability and currency acceptability. In keeping with a long-established preference for short-term lending, these banks were precluded from mortgage lending, and were authorized to establish a system of branch banking "at any place or places in the Dominion". Regulation in the 1871 Act was confined to monthly returns to the government and to the issuance of certified shareholder lists.

A number of subsequent changes in banking legislation were intended to increase the security of members of the public in their dealings with Canadian banks. In 1890, for example, a Bank Note Circulation Redemption Fund was established. Banks, at this time responsible for issuing their own notes, were required to deposit 5 per cent of their average yearly note circulation with the Minister of Finance. This fund was used to redeem the notes of a failed institution if the liquidators failed to do so. In this manner, it was hoped that noteholders would be protected from losses caused by any discounting of their holdings.

The Canadian Bankers' Association (CBA) came into existence as a voluntary organization in 1891. In 1900, the CBA, with an initial membership of 34 banks, was incorporated with the objects of generally promoting the interests and efficiency of banks and bank officers, and of furthering the education and training of bank personnel. Through the 1900 *Bank Act* revision, the CBA was assigned certain functions including control by a curator over suspended banks pending the appointment of a liquidator. The CBA also received powers to establish and operate a clearing system for the Canadian banking community. This function was transferred to the Canadian Payments Association in 1980.

Proposals for some form of external supervision of Canadian banks were put forward as early as 1880. The first form of supervision involved the use of external auditors selected in a prescribed manner. In 1913, the *Bank Act* revision introduced the requirement for external auditors to be chosen from a panel selected by the Canadian Bankers' Association and approved by the Minister of Finance. Section 56 of the 1913 statute set out procedures for the appointment of the shareholders' auditor and described the responsibilities to be carried out. Section 56A authorized the Minister of Finance to require the shareholders' auditor or any other auditor selected by the Minister "to examine and inquire specially into any of the affairs or business of the bank, and the auditor so appointed or selected, as the case may be, shall, at the conclusion of his examination and inquiry, report fully to the Minister the results thereof." By 1923, the bank audit provisions required two auditors for each bank selected from different firms and subject to replacement every two years. The auditors were required by the Act to report to the general manager and directors of the bank on any loan exceeding one per cent of paid-up capital which appeared to be inadequately secured.

Legislative changes of this nature corresponded to concern about the causes of early bank failures. The author of a major scholarly study of the growth and development of the Canadian financial system concluded that:

> ... loss of confidence in banks almost always resulted from their having made imprudent loans and investments or from suffering defalcations and almost never from external forces over which the banks had no control. It was hardly ever a case of having made good long term loans which could not be realized when depositors and noteholders for extraneous reasons demanded legal tender; but rather it was usually a case of having made imprudent loans (sometimes of a short term other times of a long term nature) which subsequently led to loss of confidence.

Shortly after the 1923 *Bank Act* revisions, the Home Bank of Canada, which had some 70 branches, failed. An inquiry under Mr. Justice H.A. McKeown was established, in February 1924, to investigate the collapse of the bank, and in particular, to consider what prior knowledge the Department of Finance may have had of the condition of the Home Bank, the effect of an audit under Section 56A of the *Bank Act, 1913* for the years preceding the failure of the bank, and "what steps, if any, could have been taken by the Government to save the situation."

The Commission reported in June 1924. In commenting on representations concerning the condition of the Home Bank made to the Department of Finance, Justice McKeown stated:

> It was therefore abundantly clear that the management of the bank had resulted in an amount over twice its paid up capital and reserve being locked up in accounts not realizable, and for the most part not bearing interest, from which it followed that whatever funds were available from day to day were those of depositors, and notwithstanding the declaration of dividends, a proper accounting would have shown that no profit at all had been made for years.

Commissioner McKeown reviewed the conduct of the Minister of Finance who was at the time directly responsible for supervisory proceedings. The Minister, in the view of Commissioner McKeown, exhibited "a lively apprehension ... concerning the position of the bank, and the desire to keep it upon its feet." The Minister had requested the bank's own auditors, rather than an outside auditor or one named by the Bankers' Association, to examine certain accounts, but no full report was ever received. Commissioner McKeown concluded: "[I]t is inconceivable, I think, that the permission of the Department of Finance, or of the shareholders of the bank, could have been procured to countenance the continuation of the then conduct of the bank's affairs, as must have been disclosed by a thorough and effective audit." He expressed the view that apart from cooperation from the Bankers' Association or from other banks, the Government, after determining the true condition of the Home Bank, "could have closed the bank and forced liquidation at a time when, in my opinion, no loss would have fallen upon the depositors." The Commissioner concluded that had the government taken any action to cause an investigation of the affairs of the bank, it would have resulted inevitably in liquidation or amalgamation of the bank.

To increase the safety of deposits, a system of government inspection was introduced in 1924. The new legislation provided for the appointment of a person who had training and experience in the business of banking to be designated as Inspector General of Banks and to be responsible for annual inspections of each bank. He made his reports on each bank to the Minister of Finance. The first Inspector General had worked in the internal inspection division of the Royal Bank of Canada. The dual auditor system described above and the Inspector General's office have together provided the basic structure of banking supervision in Canada since that time.

In the period leading up to the next decennial revision of the *Bank Act*, a five-member inquiry chaired by the Rt. Hon. Lord Macmillan of the United Kingdom judiciary was established in 1933. The inquiry was instructed to prepare "a complete and detailed examination" of the *Bank Act* and of the functions and operations of the Canadian banking system. The terms of reference further stated that the examination:

> ... should include a study of the facilities now afforded by the Finance Act and a careful consideration of the advisability of establishing in Canada a Central Banking Institution, and, if so established, of the relation of such Central Banking Institution to existing banks and its proper authority and function in the operation of the banking system of Canada.

Following a survey of the evolution of the Canadian financial system and an analysis of its operational characteristics, the Macmillan inquiry directed its attention principally to "the absence in Canada of any single banking authority which, while linked by its activities with national finance and commerce, is nevertheless detached by its constitution and the temper of its administration from the ordinary pursuits of commercial banking". The functions of a central bank were described as follows:

> In the first place, from a national point of view, the central bank, within the limits imposed by law and by its capacities, should endeavour to regulate credit and currency in the best interests of the economic life of the nation and should so far as possible control and defend the external value of the national monetary unit. In the second place, from the international point of view, the central bank by wise and timely co-operation with similar institutions in other countries, should seek, so far as may lie within the scope of monetary action, to mitigate by its influence fluctuations in the general level of economic activity. These functions do not, of course, exhaust the tasks of a central bank. Within a state the central bank should, in addition, be a ready source of skilled and impartial financial advice at the disposal of the administration of the day.

Two members of the inquiry dissented from the Macmillan report's principal recommendation that a central bank for Canada be immediately created.

No mention was made of the relationship between the proposed central bank and the already existing Office of the Inspector General. Indeed the only reference in this extensive report is to a "provision made for government inspection" in the 1924 *Bank Act* as a result of the Home Bank failure. Two provisions of the original *Bank of Canada Act* deal with the relationship between the new Bank of Canada and existing inspection arrangements. To ascertain or confirm the reserve obligations of chartered banks with the Bank of Canada, the Bank could assign its own officers to conduct an inspection of the records of any chartered bank or it could authorize the Inspector General to conduct the necessary examination. In addition, the Minister was authorized "at his discretion" to call upon the Inspector General to examine the Bank "as the public interest may seem to require". The statute incorporating the Bank of Canada did not otherwise address the exchange of information between the OIGB and the Bank.

Several provisions of the 1934 *Bank Act*, including the requirement that each bank maintain a non-interest bearing cash reserve with the Bank of Canada of not less than 5 per cent of its deposit liabilities, were introduced in anticipation of the creation of the Bank of Canada. The Bank of Canada began operation in 1935. One of its functions was as a lender of last resort to banks with liquidity problems. In this role the Bank of Canada replaced earlier measures which had been adopted as emergency measures at the outbreak of World War I when several "runs" on the banks had occurred. The *Finance Act* of 1914 had authorized advances in the form of Dominion Notes from the Government of Canada to banks and to savings banks that were subject to the *Quebec Savings Bank Act*, where liquidity difficulties arose.

The longstanding prohibition against mortgage lending by banks was removed in the 1954 *Bank Act* revision. The existing restriction reflected the traditional view that to ensure the safety of its note and deposit liabilities a bank's assets should be kept liquid. Loans therefore should generally be on demand or for short terms. The new legislation permitted chartered banks for the first time to participate in *National Housing Act* mortgages which were insured by the Government of Canada. In 1967 conventional mortgage lending (up to a 75 per cent limit on the value of the property) was authorized. This change was one of several introduced in 1967 following recommendations from the 1964 report of the Royal Commission on Banking and Finance under Chief Justice Porter.

This inquiry had been directed to report on the banking and monetary system and the institutions and operations of the capital market and to recommend legislative change as required. A central theme of its report in 1964 was the importance of sustaining and effectively regulating increased competition within the Canadian financial system which, as the inquiry clearly demonstrated, involved "overlapping of activity among institutions". The report recommended that the *Bank Act* be extended to cover a wider range of institutions which were engaged in banking.

The Commission on Banking and Finance also presented a comprehensive review of the supervision and regulation of banking institutions. The Commission concluded that "the main job of the government authority must be to stimulate the financial institutions to create their own internal regulation", and it recommended the extension of reporting, internal inspection, and outside audit requirements to all financial institutions under federal jurisdiction. In the view of the Commission certain additional powers were required in the *Bank Act* to require institutions to take such measures as were deemed necessary by regulatory authorities. A requirement for express ministerial consent and the availability of an appeal procedure would help to ensure the inquiry's objective that the proposed new regulatory power "should be used only sparingly and when attempts to persuade the institution concerned to modify unsound practices have failed." Other safeguards were elaborated:

> It is of course vital to phrase this recommended authority in such a way as to leave no doubt whatever that it relates only to the solvency and soundness of financial institutions. Its use should be accompanied by a formal statement from the supervising authority that it was being invoked for no other purpose, in order to ensure that it does not become a means for the government to direct financial institutions as to the types or amounts of assets that they must hold for reasons unrelated to the soundness of the institutions.

The proposed expansion of the *Bank Act* to cover institutions not previously within its provisions would require additions to the staff of the OIGB. The Porter Commission rejected a proposal to replace the position of Inspector General with an inspection board. The Commission also addressed staff training requirements. In so doing, the Commission rejected consolidation of the OIGB within the Bank of Canada:

> The present difficulty mentioned to us by the Inspector General of training successors to the office could be met readily in an enlarged staff by careful selection of personnel. This would overcome a problem which has led to suggestions that the Inspector should be an official of the Bank of Canada where arrangements for training and succession could easily be made. In any case, the Inspector General can do his job best as an independent official not having other interests or responsibilities which may conflict with his work. For instance, it is easy to imagine circumstances in which the central bank and the Inspector General might have different views about the need for regulation of bank liquidity. Moreover, this change in the location of the office would deprive the Minister of a valued advisor thoroughly familiar with banking matters.

Following an extended process of legislative discussion involving several draft bills in 1965 and 1966, the revised *Bank Act* came into effect in May 1967. The Porter Commission's recommendation to adopt a clear definition of the essential characteristics of banking and to bring all institutions engaged in banking under federal supervision and control was not implemented. Of the inquiry's other proposals, many were adopted in the new banking legislation. It has already been noted that the 1967 revisions permitted banks to undertake conventional mortgage lending. In addition, and again following the advice of the Porter inquiry, the interest rate ceiling on loans by a bank (6 per cent since 1944) was removed.

Reporting or disclosure requirements were also modified in 1967 with the result that hidden reserves were eliminated. The Porter Inquiry devoted considerable attention to the complex and controversial question of these reserves:

> The present chartered banks, like other financial institutions and nonfinancial companies, may set up specific reserves out of pre-tax earnings to write down the value of particular assets to their estimated realizable value; as with other taxpayers, subsequent recoveries in excess of the written-down value of the accounts concerned must be taken into taxable income. The banks, however, may also set up contingency reserves out of pre-tax income to meet unforeseen future losses, the total of these two types of reserve being subject to a limit set by the Minister of Finance.

The existence of such reserves was widely regarded as a factor contributing to the stability of the Canadian banking system, yet the importance of disclosure to provide shareholders and the public with a reliable indication of earnings trends was also recognized. As a result of the 1967 changes to the reporting schedules, information would become available to the Inspector General concerning accumulated inner reserves at the beginning of the year, additions during the year, withdrawals during the year, balance at year end, five year average of actual losses, and actual provision for losses during the year in excess of the five year average.

By means of the *Canada Deposit Insurance Corporation Act*, a federal scheme of deposit insurance was introduced in 1967. The legislation required federally regulated financial institutions, including the chartered banks and federally-incorporated trust companies who take deposits, to insure their deposits (initially $20,000 for each depositor) through premium payments to the CDIC. The CDIC was designed to operate on its insurance premiums and not on the basis of support from public funds. Provincially-regulated deposit-taking institutions were permitted to participate in the insurance arrangements subject to provincial government approval.

The most recent revision of Canadian banking legislation (the *Banks and Banking Law Revision Act, 1980*) was initiated in 1976 following the release of the *White Paper on the Revision of Canadian Banking Legislation*. The White Paper repeated the federal government's commitment to competition in the financial system:

> [T]he soundness of the basic approach to the strengthening and development of the financial system through effective and equitable competition was reaffirmed by the Porter Commission, was central to its recommendations, and remains the basic underlying objective of the government in its approach to banking legislation. ... An adequate level of competition will help to ensure that banking services are provided throughout the nation at the lowest cost to borrowers and the highest return to savers that are consistent with the survival and healthy growth of the country's financial system. Reliance on competition to achieve this objective avoids the use of restrictions which tend to dislocate markets and lead to inefficiency.

The 1980 *Bank Act* introduced a new type of bank called a Schedule "B" bank. The existing banks were classified by the Act as Schedule "A" banks. Schedule A banks, of which there are now 10, are widely held. No shareholder, whether a resident shareholder or a nonresident shareholder and his associates as set out in the Act, may own more than 10 per cent of the voting shares of a Schedule A bank. Schedule B banks in contrast are closely held in that individual shareholders and associates are permitted to hold in excess of 10 per cent of the voting securities. Schedule B banks may not open any branches, other than representative offices, outside Canada; nor, without the Minister's approval, may they open within Canada more than a head office and one branch. The size of Schedule B banks has also been restricted, initially by a provision limiting their domestic assets to 8 per cent of total bank assets. The limit has recently been extended to 16 per cent of total bank assets. All Schedule B banks are now foreign-owned.

The background to the decision to incorporate the regulation of foreign banks within the general legislative framework of Canadian banking is again set out in the 1976 White Paper. After noting the existence in Canada of foreign bank affiliates primarily incorporated under provincial company laws, the White Paper provided this rationale for the conclusion that a legislative basis for regulating the operation of foreign banks in Canada was required:

> Foreign banks are to be encouraged because the additional competitive and innovative forces that they can bring to bear in the relatively highly concentrated Canadian banking system. They are to be encouraged too because of the additional financial support which they with their world-wide connections can bring to the development of our resource industries and trade. There is also the further consideration that if we provide a basis in law for the operation of foreign banks in Canada we can expect our own banks to obtain the reciprocal recognition in other countries which is necessary if they are to extend their participation in international markets as we would like.

When finally enacted in 1980, the latest revisions to Canadian banking legislation included the previously announced power to create a bank by a special act of incorporation or by letters patent, subject to capital requirements specified by the Inspector General. The minimum capital requirements are $5M and $10M for foreign and domestic Schedule B banks respectively. The approval of the Governor in Council and, in the case of a foreign bank subsidiary, a licence issued by the Minister, are required before a bank may commence or engage in the business of banking. The licence issued to a foreign bank subsidiary is valid for a specified time period not in excess of one year.

The 1980 amendments did not alter the OIGB although, prior to 1980, several new banks had been incorporated and, by virtue of the amendments, it was sure that others would follow. In fact, approximately 60 Schedule B banks came into existence between 1980 and 1984, frequently through the transformation of foreign-owned subsidiaries which had previously been operated in Canada on the basis of provincial incorporation. Despite the considerable increase in the OIGB's inspection responsibilities this enlargement of the banking community represented, no mention was made in the new *Bank Act* of 1980 of any expansion of the staff or other resources of the Inspector General.

For discussion of the duties and responsibilities of directors, officers, auditors and regulators of Canadian banks as set out in the *Bank Act*, see Chapter 3 of this Report.

Table A.1

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Commercial Bank of Canada (1831)	Merged with Merchants Bank of Canada (1868)
Commercial Bank of New Brunswick (1834)	Failed (1868)
Gore Bank (1835)	Merged with The Canadian Bank of Commerce (1870)
Bank of Acadia (1872)	Failed (1873)
Niagara District Bank (1855)	Merged with Imperial Bank of Canada (1875)
City Bank (1833)	Merged (1876)
Royal Canadian Bank (1864)	Merged (1876)
Metropolitan Bank of Montreal (1871)	Failed (1877)
Bank of Liverpool (1871)	Failed (1879)
Consolidated Bank of Canada (1876)	Failed (1879)
Mechanics Bank (1865)	Failed (1879)
Stadacona Bank (1873)	Failed (1879)
Bank of Prince Edward Island (1865)	Failed (1881)
Exchange Bank of Canada (1872)	Failed (1883)
Union Bank of Prince Edward Island (1860)	Merged with The Bank of Nova Scotia (1883)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Bank of London in Canada (1883)	Failed (1887)
Central Bank of Canada (1883)	Failed (1887)
Federal Bank of Canada (1872)	Failed (1887)
Maritime Bank of Dominion of Canada (1872)	Failed (1887)
Pictou Bank (1873)	Failed (1887)
Commercial Bank of Manitoba (1884)	Failed (1893)
Banque du Peuple (1843)	Failed (1895)
Banque Ville Marie (1872)	Failed (1899)
Bank of British Columbia (1862)	Merged with The Canadian Bank of Commerce (1900)
Summerside Bank (1866)	Merged with Bank of New Brunswick (1901)
Commercial Bank of Windsor (1865)	Merged with Union Bank of Halifax (1902)
Exchange Bank of Yarmouth (1867)	Merged with Bank of Montreal (1903)
Halifax Banking Company (1872)	Merged with The Canadian Bank of Commerce (1903)
Bank of Yarmouth (1859)	Failed (1905)
Peoples Bank of Halifax (1864)	Merged with Bank of Montreal (1905)
Merchants Bank of Prince Edward Island (1871)	Merged with The Canadian Bank of Commerce (1906)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Ontario Bank (1857)	Merged with Bank of Montreal (1906)
Peoples Bank of New Brunswick (1864)	Merged with Bank of Montreal (1907)
Banque de St. Hyacinthe (1873)	Failed (1908)
Banque de St. Jean (1873)	Failed (1908)
Crown Bank of Canada (1902)	Merged with The Northern Bank to become the Northern Crown Bank (1908)
Sovereign Bank of Canada (1901)	Failed (1908)
Western Bank of Canada (1882)	Merged with Standard Bank of Canada (1909)
Union Bank of Halifax (1856)	Merged with The Royal Bank of Canada (1910)
Farmers Bank of Canada (1904)	Failed (1910)
St. Stephens Bank (1836)	Failed (1910)
United Empire Bank (formerly Pacific Bank of Canada) (1903)	Merged with Union Bank of Canada (1911)
Eastern Townships Bank (1855)	Merged with The Canadian Bank of Commerce (1912)
Traders Bank of Canada (1884)	Merged with The Royal Bank of Canada (1912)
Bank of New Brunswick (1820)	Merged with The Bank of Nova Scotia (1913)
La Banque Internationale du Canada (1911)	Merged with Home Bank (1913)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Bank of Vancouver (1908)	Failed (1914)
Metropolitan Bank (1902)	Merged with The Bank of Nova Scotia (1914)
Quebec Bank (1822)	Merged with The Royal Bank of Canada (1917)
Bank of British North America (1836)	Merged with Bank of Montreal (1918)
Northern Crown Bank (1903)	Merged with The Royal Bank of Canada (1918)
Bank of Ottawa (1874)	Merged with The Bank of Nova Scotia (1919)
Merchants Bank of Canada (formerly Merchants Bank) (1861)	Merged with Bank of Montreal (1922)
Bank of Hamilton (1872)	Merged with The Canadian Bank of Commerce (1923)
Home Bank of Canada (1903)	Failed (1923)
La Banque Nationale (1859)	Merged with La Banque d'Hochelaga (later Banque Canadienne Nationale) (1924)
Sterling Bank of Canada (1905)	Merged with Standard Bank of Canada (1924)
The Molsons Bank (1855)	Merged with Bank of Montreal (1925)
Union Bank of Canada (formerly Union Bank of Lower Canada) (1865)	Merged with The Royal Bank of Canada (1925)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Standard Bank of Canada (1872)	Merged with The Canadian Bank of Commerce (1928)
Weyburn Security Bank (1910)	Merged with Imperial Bank of Canada (1931)
The Dominion Bank (1869)	Merged with The Bank of Toronto to become The Toronto-Dominion Bank (1955)
Barclays Bank (Canada) (1929)	Merged with Imperial Bank of Canada (1956)
Imperial Bank of Canada (1873)	Merged with The Canadian Bank of Commerce to become the Canadian Imperial Bank of Commerce (1961)
Unity Bank (1972)	Merged with Banque Provinciale du Canada (1977)
Banque Provinciale du Canada (formerly Banque Jacques Cartier) (1861)	Merged with Banque Canadienne Nationale (1979)
Canadian Commercial Bank (formerly Canadian Commercial and Industrial Bank) (1975)	Failed (1985)
Northland Bank (1975)	Failed (1985)
Mercantile Bank of Canada (1953)	Merged with Banque Canadienne Nationale (1986)
Bank of Montreal (1822)	Still active
Bank of Nova Scotia (1832)	Still active
Toronto-Dominion Bank (formerly The Bank of Toronto) (1855)	Still active

Table A.1 (conc'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
The Canadian Imperial Bank of Commerce (formerly Canadian Bank of Commerce) (1867)	Still active
The Royal Bank of Canada (1869)	Still active
Banque Canadienne Nationale (formerly La Banque d'Hochelaga) (1873)	Still active
Bank of British Columbia (1967)	Still active
Continental Bank of Canada (1977)	Still active
Western & Pacific Bank of Canada (1983)	Still active
Bank of Alberta (1984)	Still active

From 35 active banks at the end of Confederation year, the Canadian banking system expanded to include 51 active banks in 1874, a nineteenth-century peak not exceeded until the introduction of Schedule B banks following the 1980 revisions.

From Confederation to 1900, 24 banks disappeared. Seven of these were merged out of existence, while 17 failed or had their charters repealed. An amendment introduced by the *Bank Act* of 1900 eliminated the requirement that mergers take place only by special act of Parliament. Thereafter, mergers required only the approval of the Governor in Council pursuant to a recommendation of Treasury Board. The significance of this change is evident in the statistics on disappearing banks from 1900 to 1926 when mergers accounted for the disappearance of 27 out of 35 banks. Eleven banks remained active in 1926.

The failure of the Home Bank and a series of mergers in the early 1920s had reduced the number of banks active in Canada from 18 at the outset of the decade to 11 by the end of 1925. In the succeeding four decades, only the formation of the Mercantile Bank of Canada in 1953 altered the measured decline in the number of Canadian banks to a 1961 low of eight institutions. In the late 1960s however, interest in the formation of new banks revived. The Bank of British Columbia was established in 1967 along with the Bank of Western Canada which never came into operation. The Unity Bank of Canada was established in 1972.

At the Western Economic Opportunities Conference in July 1973, further pressure for the creation of new banks came from the western provinces. In a joint submission, the governments of the four western provinces stated:

> The branch banking system, characterized by the five major Canadian chartered banks with branches coast to coast, and head offices in central Canada, has not been adequately responsive to western needs.

To alleviate what they regarded as a bias towards the interests of central Canada on the part of the major chartered banks, the western provinces urged the formation of independent regional banks in Western Canada:

> Western-based banks in which there was a degree of public participation would be more sympathetic to the needs of residents of the West and the major chartered banks. In particular, they could provide a substantially greater amount of financial capital than in the past to rural and urban communities and would facilitate an expansion of the productive capacities of the western provinces' economies. They would infuse effective competition into the banking industry in the securing of deposits and the making of loans and by extending considerably greater assistance to small-scale and risky ventures. Increased competition for business would induce the established chartered banks to improve the quality of services provided to residents of Western Canada.

Citing the experience of the Bank of British Columbia, then Minister of Finance John Turner expressed his sympathy for the creation of more western banks, and indeed more banks generally, to enhance competition. He announced the willingness of the federal government to recommend that the incorporation of new banks be permitted through letters patent to eliminate the cumbersome and expensive special act requirements of existing legislation.

The Canadian Commercial Bank (initially the Canadian Commercial and Industrial Bank) and the Northland Bank were created in 1975. Parliament granted the CCB charter on 30 July 1975. The Northland Bank obtained its charter on 20 December 1975. The

Continental Bank of Canada came into existence in 1977. All of these banks were established by act of Parliament. Two more small western banks were granted letters patent in 1983 and 1984.

Although the last Canadian chartered bank to fail before the events leading to the appointment of this Commission was the Home Bank in 1923, it would be wrong to equate this 60-year lull in bank failures with a completely untroubled banking scene. Nine further banks had ceased operating between 1924 and 1977. After a few years of operation the loan portfolio of the Unity Bank of Canada deteriorated significantly. When Unity's problems persisted despite a change in management, and in the light of unfavourable media commentary, the OIGB participated in discussions aimed at obtaining liquidity funding from the Bank of Canada and the CDIC. This liquidity support provided temporary stability and permitted the eventual merger of the Unity Bank in 1977 with the Provincial Bank (which in 1979 merged with the National Bank of Canada). The restructuring of the Canadian banking system through merger has continued, most recently involving the merger of the Mercantile Bank of Canada with the National Bank of Canada in 1986.

It is further relevant to note that since the late 1960s, the CDIC has been actively involved in working out, by one means or another, difficulties in a number of trust and loan companies which raise many of the same problems as bank failures.

Appendix B

Bank Supervision in the United Kingdom and the United States

A. The United Kingdom
   1. The Financial System
   2. Supervision of Banking in the United Kingdom
   3. "The Lifeboat" and the Johnson Matthey Bankers Failure
   4. Proposed Changes to United Kingdom Bank Supervision

B. The United States of America
   1. Introduction to Bank Supervision in the United States
   2. U.S. Federal Regulation of Commercial Banks
      a. The Office of Comptroller of the Currency
      b. The Federal Reserve System
      c. The Federal Deposit Insurance Corporation
      d. Other Regulatory Authorities
   3. The System of Supervision in the United States
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   5. Public Disclosure of Cease and Desist Orders in the United States
   6. Proposed Changes to U.S. Bank Supervision

C. Conclusion

Appendix B

Bank Supervision in the United Kingdom and the United States

A. THE UNITED KINGDOM

1. The Financial System

The financial system of the United Kingdom is made up of a central bank, that is The Bank of England, (hereafter the Bank) commercial banks, merchant banks, and savings banks. In addition, there is a host of lesser, specialized financial institutions such as credit unions, building societies, and discount houses. Under the *Banking Act, 1979*, two categories of institutions are authorized to take deposits; "recognized banks" and "licensed deposit-taking institutions" (LDTs).

Of the 290 recognized banks and 315 LDTs operating in the United Kingdom at 28 February 1985, 250 were overseas institutions with U.K. branches, 65 were subsidiaries of overseas institutions and 24 were joint venture operations between overseas and, in some cases, U.K. institutions.

Under s. 3 of the *Banking Act, 1979*, the Bank of England is responsible for the recognition and licensing of banks and LDTs. It is not clear from materials available to the Commission to what extent the political processes play a role in the decision whether to allow new institutions to be licensed. However, certain objective minimum criteria are set out in Schedule 2 to the Act, and the Bank is directed to refer to these in making its decision. These criteria include, in the case of recognized banks, "a high reputation and standing in the financial community", provision of either a wide range of banking services including deposit-taking, overdraft or loan financing, foreign exchange services, commercial financing and financial advice, or provision of a highly specialized banking service. In addition, a bank is required to be carried on with integrity, prudence and the necessary professional skills, to be effectively directed by at least two individuals, to have net assets of at least £5M, if it will provide a wide range of services, or £250,000, if it will provide highly specialized services, and to maintain what the

Bank determines are appropriate levels of paid-up capital and reserves. Because of the requirement relating to reputation and standing, recognition as a bank is granted only to those institutions with proven track records. No matter how fully capitalized a new institution may be, it cannot enter the market as a bank without having spent a period of time under the LDT designation.

The licensing criteria for LDTs are less onerous. An LDT must be controlled by at least two persons who are "fit and proper" to hold their positions, must possess net assets of at least £250,000 and must carry on business in a prudent manner, maintaining a level of assets determined to be appropriate by the Bank and adequate liquidity, and making adequate provision for doubtful debts and contingent obligations.

The English system prior to the mid-1960s was composed of institutions informally recognized by the banking community as banks, and other deposit-taking institutions, which were not banks properly so called. Whether an institution was a "bank" was determined mainly by the banking community and the Bank, which would grant a series of "recognitions" to the institution, and only secondarily according to legislative criteria. Only banks were subject to the ongoing, but quite informal supervision of the Bank of England.

This arrangement had become confused by the mid-1970s, due to a conjunction of economic and legislative factors. These conditions culminated in a series of events known as the "secondary banking crisis". Liquidity problems affecting a nonbank deposit-taking institution which was not formally regulated or supervised by the Bank led to a lack of confidence in all such institutions, and threatened to infect the banking system proper as well. A support strategy, called "the lifeboat" (described in greater detail below) was put in place to avert this threat to the system, and in 1979, the *Banking Act* was amended to institute the formal, two-tiered system now in place. It was intended that the divisions would serve to put the public on notice that certain institutions are not as mature as others and, in addition, would allow a two-tiered system of supervision; that is, recognized banks would be subject to a less formal supervisory regimen than LDTs. In recognition of their often greater riskiness, LDTs would be subject to more detailed supervision by supervisors operating with a heightened state of awareness.

The two-tiered system has recently been criticized by the Committee Set-Up to Consider the System of Banking Supervision. The Committee wrote, with the benefit of the Johnson Matthey experience (described in greater detail below) that the system had not been successful in achieving its objectives. This conclusion was accepted by the Government in its White Paper on Banking Supervision.

The current U.K. system of bank supervision reflects an apparent preference for voluntary self-regulation. The legislators in the United Kingdom recognize that the reduction (but perhaps not the elimination) of risk of loss to depositors is necessary in the interests of the requirement of financial stability. However, the legislators do not accept that the answer to risk reduction is a complex set of regulations. Rather, financial institutions in the United Kingdom are expected to maintain sound practices independent of regulation. Unhappily, reliance upon a purely self-regulatory system has proven increasingly hazardous and the government has expanded, and plans further use of, imposed prudential controls. However, the heavy costs associated with a more paternalistic regulatory scheme have caused Parliament to move reluctantly from self-regulation until a clear need is established.

2. Supervision of Banking in the United Kingdom

The Bank was established in 1694 by a charter granted under letters patent pursuant to an Act of Parliament, and in 1946, was brought into public ownership. The formal head of the Bank is the Chancellor of the Exchequer although, within the staff of the Bank, the Governor is the chief official. The Governor is appointed by the Queen on the advice of the Prime Minister for a renewable five-year term. By tradition, the Governor has usually been a senior banker drawn from the merchant banks. The Governor sits at the head of the "Court of Directors". Apart from the Governor, the directorate is comprised of the Deputy Governor, four executive directors and twelve individuals from outside the Bank, each appointed for a renewable four-year term. At the present time these directors control all functions of the Bank.

The Bank's principal functions are those common to many central banks. These responsibilities include the management of currency issuance, foreign exchange reserves and the national debt, the provision of advice to government on monetary and economic policy, the responsibility to act as banker to the government, the responsibility as lender of last resort and the duty to regulate the banking system. The Bank also has a large role in the deposit protection scheme, which secures up to 75 per cent of the first £10,000 of a depositor's deposits with any one institution. Pursuant to Schedule 5 of the *Banking Act, 1979*, the "Deposit Protection Board" comprises the Governor, Deputy Governor and Chief Cashier of the Bank, plus three persons appointed from the contributory institutions. The insurance fund is financed by a charge on all authorized institutions in proportion to their deposit base.

The Banking Supervision Division of the Bank is responsible for supervising both LDTs and recognized banks. In 1985, this Division employed 94 people directly in an analytical or supervisory role and a further 36 in a supporting capacity. The Bank's method of supervision of all recognized banks involves both quantitative and qualitative analysis. Supervision is based upon the systematic analysis of regular (usually quarterly) statistical returns and, also, regular prudential discussions with management.

The statistical returns are, generally, intended to elicit pertinent information respecting three main aspects of a bank's performance; capital adequacy, liquidity, and portfolio distribution. The Bank obtains a variety of quarterly returns dealing with (a) the capital base, the profit and loss development over the latest quarter, the operating expenses, loans and advances, income from fees and commissions, large exposures, and any form of connected lending; (b) the liquidity position and maturity analysis of liabilities and assets; and (c) a maturity analysis of liabilities and assets in currencies other than sterling. A balance sheet return is provided monthly by major banks and quarterly by smaller institutions. Other returns require breakdowns of provisioning for losses, sovereign debt exposure, and so forth. These various returns are not required to be audited but they must be certified to be true by a director or senior officer of the reporting institution.

The Banking Supervision Division has set out for the banking industry its approach to the assessment of capital adequacy, liquidity and portfolio distribution in three papers published by the Bank in or about September 1980, July 1982, and April 1981. The Bank's assessment of capital adequacy of banks incorporated in the United Kingdom is based upon two ratios, the "gearing ratio" and the "risk asset ratio". The former relates current, noncapital liabilities to the bank's adjusted capital base. The latter, which is regarded by the Bank as the more important for supervision purposes, measures the adequacy of capital in relation to the bank's exposure to risk of losses.

In the calculation of the "risk asset ratio", weightings are ascribed to various classes of assets according to their susceptibility to the risk of loss. The adjusted capital base is measured against the total of weighted assets, and a ratio is set for each bank having regard to its particular character and its exposure to various categories of risk, including risk arising from concentration.

The Bank does not set uniform liquidity guidelines for banks. It has been accepted that liquidity needs must be determined by individual circumstances. Liquidity assessments by the Bank take into account, for example, an institution's cash flow provided by maturing assets, its holdings of marketable assets, the structure of its deposit base, and any standby facilities which can be counted on as a reliable source of funds in times of difficulty. Portfolio distribution is carefully watched. For instance, the Bank requires a bank to justify exposures to a single borrower or a group of closely related borrowers in excess of 10 per cent of the lending bank's capital base. The Bank has also proposed an absolute limit of 25 per cent on such exposures. These limits do not apply to inter-bank, country or sectoral exposures, which are watched separately.

Systematic analysis of statistical returns is supplemented by a less systematic interview and discussion procedure. At these "prudential interviews" senior management of the supervised institutions are evaluated and asked for further information concerning such matters as quality of capital, profitability, and business prospects. "Prudential interviews" do not necessarily occur after each quarterly return. For LDTs, the interview process may occur between two and four times a year. For branches of overseas banks, there may be only a single interview annually. Interviews for larger banks vary in frequency, but usually occur several times a year. In light of obligations imposed on the United Kingdom in 1983 under the European Communities Consolidated Supervision Directive, the Bank of England has reviewed its approach to the consolidated supervision of groups containing a bank. "Where a bank is part of a group, supervision of the bank must encompass the activities of the other group companies since their strengths and weaknesses will have implications for the soundness of the bank."

Charles F. Green of the National Westminster Bank stated that at his bank such interviews take place at three levels. One of the senior executive directors of the central Bank has a bi-annual meeting with the chief executive of the National Westminster group to discuss general strategies, performance, and prospects. At the second level, the heads of the major operating divisions of the National Westminster group attend at the Bank twice a year to report on operations. The third level of interviewing is conducted with the subsidiary banks belonging to the National Westminster group. The questioning at the third level is more detailed and specific and the chief executives of the subsidiaries are expected to disclose the performance of their banks as frequently as twice a year. Section 17 of the *Banking Act, 1979* provides a broadly worded authority for on-site inspection where it appears desirable in the interests of depositors. The Banking Supervision Division does not, however, carry out on-site examinations on a routine basis, and the power has in fact rarely been exercised.

The *Banking Act, 1979* imposes no special auditing requirements on recognized banks. All such institutions are subject to the same auditing requirements as are imposed on U.K. companies in general. Every corporation has a duty to appoint a properly qualified, professional accountant to conduct an annual audit. Most recognized banks in the United Kingdom employ one firm of external auditors, although because of past mergers some of the largest banks may employ two or more external auditors to review their financial statements. The most startling aspect of the role of the external auditor in the United Kingdom is that, at writing, the auditor has no duty to report or provide any information whatsoever to the supervisory staff at the Bank. This is so because of the traditional observance of strict laws against disclosure of information about bank customers, auditors' information, and banking information generally. The banking supervisors have no control over the appointment or removal of the external auditors and cannot seek disclosure from the auditors of information respecting any aspect of the condition of the supervised institution. This prohibition on dialogue between the auditors and supervisors has been recognized as a significant weakness in the existing system of supervision. Legislation is anticipated shortly which will enable and encourage communication between auditors and regulators.

The supervision method of the Bank cannot be characterized as being immediate or direct. There are no first hand examinations of asset quality. Country and sectoral exposures of supervised institutions, their profitability, managements, control systems, loss provisioning practices, and so forth are all evaluated at some distance by means of information returns or discussions which are only as detailed as management might feel compelled to make them. Furthermore, the present system of supervision in the United Kingdom provides no specific tools to enforce compliance by banks with directions of the Bank except the threat of revocation of authorization. To date, moral suasion has been the Bank's principal tool of enforcement.

3. "The Lifeboat" and the Johnson Matthey Bankers Failure

By the early 1970's, the British banking system's traditionally informal structure had permitted a large number of nonbank deposit-taking institutions to be established. These were not subject to Bank of England supervision and control, but were certified as banks for limited statutory purposes under the *Companies Act, 1967* on the basis of functional tests which did not assess the quality of their operations. In an era of speculative activity in property development, these companies became increasingly dependent upon money market funds.

Liquidity problems developed when at least one of these nonbank institutions was unable to renew essential money market deposits. This led to a crisis of confidence which rapidly infected other nonbank deposit taking institutions, and would, it was feared, have extended into the banking system proper. To counter this threat, the Bank, in conjunction with English and Scottish clearing banks, mounted a rescue operation. The Bank responded immediately to the crisis with a variety of *ad hoc* arrangements to deal with the initial casualties. It later moved to create a more formal structure, consisting of a Control Committee composed of senior representatives of the Bank and the clearing banks under the chairmanship of the Deputy Governor of the Bank. This Committee was colloquially referred to as "the lifeboat".

Investigation of a problem institution was carried out by the bank identified as having the closest business connection with the troubled institution. That bank would report back to the Committee, which would then decide whether to provide support. According to a Bank of England Quarterly Bulletin, the criteria upon which this decision was based were straightforward. The Committee had to be satisfied, on the basis of the best available evidence, that the institution was trading solvently and would remain in that state with the provision of liquidity support. Second, a judgment was made as to whether the institution had "sufficient banking characteristics" and had attracted "a significant level of deposits from the public". Finally, the Committee would make advances only if the institution had no institutional shareholders which might themselves provide liquidity support. It was recognized in this process that some problem institutions would be allowed to fail. Varying degrees of support were eventually given to 26 companies, of which a small number were authorized banks. The total advanced amounted to approximately £1.2B. Eight of the companies receiving support were ultimately placed in receivership or liquidation, and only four, by June 1978, were still relying on lifeboat funds.

Where liquidity support was given, measures such as the recycling of withdrawn deposits through the clearing banks and back to the original bank, and liquidity loans from the Bank and the participating clearing banks were used. The risk was in most cases shared by all members of the Committee based on a formula which took account of the relative size of their eligible liabilities. The Bank coordinated the provision of support. Interest was charged on the advanced funds at a commercial rate. This was intended as an incentive to the institution to regenerate its own funding capability. Where necessary, this strategy was modified to recognize the risk of prejudice to the supported institution's ability to survive. Security was taken for the support lending where appropriate and available.

In 1975 and 1976, Bank programs were extended without participation by the other members of the lifeboat. In two cases of particular significance, banks which were part of large groups with diverse interests were acquired in reconstruction schemes, and are still owned by the Bank. The Bank has retired the claims of depositors over a period of time and realized upon the loan portfolio to the extent possible. The extent of the exposure of the Bank in these two bank failures is not disclosed but the impact upon the banking community and the banking regulatory community was unquestionably extensive and fundamental.

The second crisis to affect the British banking system occurred in the autumn of 1984 when the Bank was faced with the sudden insolvency of Johnson Matthey Bankers Limited (JMB). JMB was a recognized bank established in 1965 to conduct the banking and bullion business of Johnson Matthey p.l.c., a member of the London Bullion Market. JMB's business was concentrated in bullion, foreign exchange, and trade finance. No attempt was made to diversify its business, although it did become involved in other financial services through the purchase of subsidiaries.

Mainly as a result of disastrous downturns in the performance of a few large loans, JMB's loan portfolio was, by mid-1984, in such a state that provisions for losses required against bad debts would wipe out its capital and reserves. The inadequacy of management and internal controls at JMB had contributed to this situation. The Bank of England, subsequently reported that insufficient attention had been paid to the concentration of risks (the two largest loans contributing to the failure were together, by 1984, equivalent to more than 100 per cent of the bank's capital base), that normal banking practices relating to the taking of security were not followed, and that where security was taken, appropriate steps to ensure the Bank's claim were not always taken. Additionally, the Bank found that JMB's management had failed to exercise proper caution in deciding on the need for provisions against bad or doubtful debts (JMB had adopted the unusual policy of not taking provisions on a loan-by-loan basis, but of writing off losses as they actually occurred), and had shown poor judgment in approving so many loans which ultimately turned out to require substantial provisions.

At the Bank's regular prudential interviews with JMB management in 1983 and 1984, inadequate liquidity and the scale of JMB's exposures were raised as concerns, but these matters seemed to have been dealt with to the Bank's satisfaction. The Bank's appreciation of the true state of affairs at JMB, however, was substantially diminished by the fact that reporting from the bank was both late and seriously inaccurate. Thus by the time the Bank was informed by JMB of its impaired state, only limited courses of action remained open to the supervisors.

The first step taken was to have JMB's external auditors, and then a team from the clearing banks, review a wide cross-section of the loan portfolio of the bank. These two investigations revealed that the necessary provisioning would more than exhaust JMB's capital. This finding was confirmed independently by auditors hired by the Bank. It being clear that more than provision of liquidity support would be required to revitalize the bank, the Bank attempted to find a buyer to recapitalize it, but with no success. All these steps were taken in secrecy, between the 25th and the 30th of September 1984. The Court of Directors of the Bank then decided to purchase (in effect to nationalize) JMB and its subsidiaries for a nominal sum and, thereafter, to write off the enormous loan losses. Johnson Matthey p.l.c. agreed to provide £50M, and undertakings to contribute support were also secured from the other banks and members of the gold market. The Bank provided JMB with an indemnity of up to £150M to meet losses, and made a temporary deposit of £100M. The other banks and gold market members agreed to counter-indemnify the Bank for a total of half of any such losses, to be shared among the various categories of contributors according to a prearranged formula. Once the Bank had acquired JMB, the board of directors was reorganized. The new Chairman was an executive director of the Bank, and other new board members had varied banking experience. New executive, credit, audit, and staff committees were formed. The new board became involved in reviewing in detail the loan portfolio and in establishing the necessary level of provisioning against bad debts. Comprehensive review and restructuring of lending operations was commenced with the assistance of some 35 secondees from other banks and outside consultants. With disposition of JMB in mind, the Bank announced, prior to its year end in February 1985, a reorganization of JMB's capital base, involving the cancellation of 75 million issued and unissued ordinary shares and subscription by the Bank of £75M in fresh equity.

The decision to rescue JMB, a relatively small and specialized bank, was apparently made by the Bank, the commercial banks and the other members of the gold market in the belief that the failure of JMB would have had an injurious effect on the London gold market, and that the crisis of confidence which might have occurred could have spread to other British banks and possibly also to banks elsewhere. Underlying all of this was a desire not to damage London's standing as the world's most important international gold market, a consciousness of the precariousness of confidence in financial markets generally following the Continental Illinois crisis in the United States, and a fear that a run on British banks would damage the pound.

4. Proposed Changes to United Kingdom Bank Supervision

It was widely agreed that the circumstances surrounding the lifeboat and the JMB rescue exposed the adequacy of the Bank's supervision system to question. Consequent upon the collapse of JMB, a Committee, led by the Governor of the Bank and including other members drawn from the Bank and a crown corporation not engaged in banking, was set up to consider the supervisory system and whether any changes in supervisory procedures were required. In particular the Committee was asked to examine the relationship between external auditors and supervisors, the handling of concentrations of risk and the assessment of the quality of assets, the notification process and collection of statistics, the adequacy of Banking Supervision Division of the Bank of England, and whether the *Banking Act, 1979* required changes. The Committee made various recommendations in June 1985.

The Committee did not examine in any detail the merit of changing to a basically different supervisory system. It was concluded that there were no fundamental flaws in the system of supervision in the United Kingdom but that certain improvements could be devised to correct some existing weaknesses.

The Committee founded its work upon certain fundamental assumptions which have value in a discussion of the Canadian system of bank supervision. Concerning the principles of U.K. bank supervision, the Committee stated:

> Continued reliance on a flexible system has three major implications. First, if the Bank is not itself to carry out detailed inspections of banks' books, it must be able to rely on the assistance and cooperation of the professional firms who do carry out this task: the bank's auditors. We believe it is important that coordination and contact between supervisors and auditors be improved in a number of ways. Secondly, it requires the continued cooperation of the banks which are supervised. We believe that the existing high level of cooperation between the banks and the supervisors can be maintained and that banks will remain responsive to the concerns of the supervisors. The system cannot, however, rely totally on this responsiveness in all circumstances; the supervisors must have adequate powers to deal with cases where this cooperation is not forthcoming. Thirdly, we believe that for the proper working of the present system, it is essential to improve the capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan book, the adequacy of capital and other elements of the business of the banks which they are supervising.

The Committee recommended that the present two-tiered system of authorization be replaced by a single authorization to take deposits and that new, stricter criteria for authorization be imposed; that communications between management, supervisors and auditors of banks be improved through the introduction of a mechanism to enable a regular dialogue between supervisors and auditors free from confidentiality restraints, in exceptional circumstances without the presence of representatives of the particular bank; that the Bank should be granted the power to require that, when necessary, statistical returns used for supervisory purposes be examined by the auditors; and that the Bank be empowered to demand a second audit of a bank's accounts where that bank's auditors are considered incompetent or negligent.

In relation to the supervision of asset quality, the Committee recommended that the Bank improve its methods for evaluating banks' control systems, increase the visits to banks and undertake, more readily than before, detailed investigations of problem banks. The Committee also recommended that the Bank tighten procedures to ensure that statistical information is returned in a timely fashion, and to improve the performance of the Banking Supervision Division by increasing numbers of staff and upgrading staff qualifications.

Many of the Committee's recommendations were adopted in the White Paper on Banking Supervision recently tabled in Parliament by the Chancellor of the Exchequer. The White Paper concentrated on improving the existing supervisory regime by strengthening those features which have a direct bearing on the flow of accurate and worthwhile prudential information to competent supervisors.

Certain of the White Paper recommendations merit comment. Consideration was given by its authors to separating the function of banking supervision from the the Bank. Advantages, such as the avoidance of conflicts of interest and the desirability of focusing talent and discussion in a specialized bank supervision body, were discussed. However, radical restructuring of the basic British supervisory system was rejected. Instead, it was recommended that in order to achieve some independence from the Bank for the supervisors, banking legislation provide for a body within the Bank, the Board of Banking Supervision, to assist the Governor of the Bank in banking supervisory activities. The Board is to consist of the Governor and Deputy Governor of the Bank and the Executive Director responsible for Banking Supervision as permanent *ex officio* members, together with five other members selected by the Governor of the Bank with the agreement of the Chancellor of the Exchequer from outside the Bank. In the main, these members would be retired senior bankers and members of the legal and accounting professions. The aim is to integrate regulatory, banking, legal and accounting perspectives. The Board's responsibility is to report on banking supervision matters directly to the Governor. Its mandate is proposed to cover review of principles of banking supervision relating to such matters as capital adequacy and liquidity, review of developments in supervisory practice, administration of new supervisory legislation, and staffing and training of the Banking Supervision Division of the Bank. Its functions would include review of the regular reports from the Supervision Division and reporting to the Governor on these, including, where required, reference to individual cases. Should the Governor choose not to follow the advice of the Board, the Governor would be required to so report to the Chancellor of the Exchequer.

In addition to grafting this new forum onto the Bank of England structure, the White Paper recommends upgrading and increasing the staff of the Banking Supervision Division. In particular, it is recommended that there be appointed to the staff persons with accounting and legal training, and that by secondment, experienced banking personnel should join the staff of the Supervision Division. Conversely, members of that staff should be seconded to the banks for banking experience.

In short, the White Paper recommendations propose to increase the level of mandatory reporting to the Bank's supervisors, and to increase the effectiveness of that reporting through greater supervisory expertise and increased liaison between the supervised banks and the supervisors. Reliance on confidential supervision is maintained, and an on-site investigative model used in the United States was specifically rejected. If the White Paper proposals are implemented, the British banking system will continue to rely heavily on bank self-regulation, but in a strengthened system with prudential limitations imposed through an increased scope of regular mandatory reporting, backed up by criminal sanctions.

Some criticism of the U.K. proposals for change has come from financial commentators. Their attack is largely on the basis that the proposed changes deal only with the mechanical aspect of the system and not with the fundamentals. They have criticized the supervision system for being a closed circuit with little or no information getting out to investors, depositors, customers and the public generally concerning the state of the banks. Comparisons are drawn between the amount of disclosure required of U.K. banks and the Bank of England and disclosure requirements in the United States. The comment was made in the Financial Times of London on 18 December 1985: "None of this information concerning nonperforming loans, reserves and so on is required of British banks except ironically, three or four clearers, who have chosen to issue securities in New York and thus to meet the New York Stock Exchange standard." The article concludes: "Secrecy is a moral hazard to central banking itself." Thus tension persists between the essential security of the bank in the community and the concomitant need of the community for information concerning bank security so that appropriate and timely curative action may be taken by the community to preserve that very security.

B. THE UNITED STATES OF AMERICA

1. Introduction to Bank Supervision in the United States

The banking system of the United States is staggeringly large and complex. So too is the banking regulatory system. At the end of 1983 there were 4,772 commercial banks established under federal laws and 9,691 commercial banks established under state laws. According to the 1984 Report of the Task Group on Regulation of Financial Services (the "Bush Task Group"), 80 per cent of U.S. commercial banks were minor entities, having assets of $100M (U.S.) or less; and 40 per cent had assets of $25M (U.S.) or less. The U.S. banking regulatory system has grown to the point that the seven federal agencies which operate the federal system have more than 38,000 full time employees. The three main federal banking agencies, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (COC), and the Federal Deposit Insurance Corporation (FDIC), have more than 7,000 full time employees engaged in purely regulatory activity, including the supervision and other aspects of the regulation of banks. These three principal federal banking agencies spent approximately $173M (U.S.) on examinations alone during 1982, and in 1985, this figure is estimated to have reached $204M (U.S.). There is no readily available information as to the amount spent annually on examinations by the state regulatory authorities, however, statistics provided by the Conference of State Bank Supervisors reveal that the projected 1986 consolidated budget for 50 state banking agencies is approximately $250.5M (U.S.)

A variety of deposit-taking institutions operate in the United States. In the order of their respective market shares these deposit-taking institutions include commercial banks, savings and loan associations, savings banks (referred to generically as "thrift institutions"), and credit unions. These deposit-taking institutions are regulated by an assortment of federal and state agencies. Generally speaking, federal regulatory authority over commercial banks is shared by the COC, the FRB, and the FDIC. The savings and loan associations and the savings banks are primarily regulated by the Federal Home

Loan Bank Board and to some extent by the Federal Savings and Loan Insurance Corporations. Credit unions are regulated by the National Credit Union Administration.

2. U.S. Federal Regulation of Commercial Banks

The regulation of commercial banks is divided among the COC, FRB, FDIC, various state agencies, the Securities and Exchange Commission, and the Anti-Trust Division of the Department of Justice.

In the United States, banks may be chartered by either the COC or individual state chartering authorities. The COC has statutory authority to regulate all "national", that is federally chartered, banks. The FRB has statutory authority to regulate all national-charter or state-charter members of the Federal Reserve System, bank holding companies of both national and state nonmember banks and their nonbank subsidiaries, the international activities of banks and bank holding companies, and the U.S. banking and nonbanking operations of foreign banks. The FRB exercises a primary supervisory responsibility only for those member banks that are state-chartered, recognizing that the COC has primary responsibility for the supervision and examination of nationally chartered member banks. The FDIC has statutory authority to regulate all national-charter or state-charter banks insured by it, although its principal supervisory responsibility is over those insured state banks which are not members of the FRB. Because a single bank may fall under the authority of more than one federal agency, the agencies have attempted to coordinate their efforts to reduce duplication of regulatory effort.

In 1978, coordination efforts reached a high level of formality with the formation of the Federal Financial Institutions Examination Council which is empowered to work towards the elimination of regulatory overlap. As a matter of practice in the area of bank examination, the COC now examines all national banks. The FRB examines only state-chartered banks that are members of the Federal Reserve System ("state member banks"), bank holding companies and their nonbank subsidiaries, the international activities of banks and bank holding companies, and the U.S. banking and nonbanking operations of foreign banks. The FDIC examines only insured state-chartered banks that are not members of the Federal Reserve System ("state nonmember banks"). The FDIC or FRB, as the case may be, share the regulatory role with the particular state regulatory authority where a state bank opts for Federal Reserve System membership or federal deposit insurance protection.

a. *The Office of Comptroller of the Currency*

The powers of the COC were originally established under the *National Currency Act* of 1863 and the *National Bank Act* of 1864. The chief administrator of the agency is the Comptroller of the Currency who is appointed by the President and confirmed by the Senate for a term of five years. This official operates from the main bureau in Washington under the general direction of the Secretary of the Treasury. The principal functions of the COC are to charter national banks, to issue rules and regulations governing the corporate structure of national banks and their lending and investment practices, to determine when national banks become insolvent and to appoint the FDIC as receiver of such banks, and to monitor and examine national banks so as to ensure that they operate legally and soundly. To carry out its examination responsibilities for approximately 5,000 banks, the COC has approximately 2,200 examiners based in six regional offices, including full-time examiners at each of the largest national banks in the United States. The COC is entirely financed by assessments on the banks.

Under 12 U.S.C. s.24, a national bank comes into existence on incorporation, but cannot commence banking activities until the Comptroller issues a certificate of authority to commence banking pursuant to 12 U.S.C., ss. 26 and 27. Minimum capitalization requirements of $100,000 (U.S.) are established under 12 U.S.C. s. 51. In March 1985, the COC promulgated final rules raising capital requirements as a percentage of total assets for all nationally chartered banks to 6 per cent, of which 5 per cent is primary capital. Primary capital is defined as the sum of common stock, perpetual preferred stock, capital surplus, undivided profits, capital reserves, mandatory convertible debt, minority interests in consolidated subsidiaries, net worth certificates issued pursuant to 12 U.S.C. s.1823(1), and the allowance for loan and lease losses. The FDIC simultaneously issued final rules raising capital requirements for state nonmember banks to the same levels.

There does not appear to be any direct involvement by the executive branch in the issuance of the certificate of authority to operate by the Comptroller. The statutory factors which the COC must consider in deciding to approve or disapprove new banks are the bank's future earnings prospects, the general character of its management, the adequacy of its capital structure, the convenience and needs of the community to be served by the bank, the financial history and condition of the bank, and whether the bank has complied with the provisions of the ***National Bank Act*** and the ***Federal Deposit Insurance Act***.

The determination of insolvency of nationally chartered banks is made by the Comptroller pursuant to 12 U.S.C. s.191 where the Comptroller is satisfied of the insolvency of the bank, or pursuant to 12 U.S.C. s. 192, when an association has failed to pay its circulating rates as they become due. Under 12 U.S.C. s. 1821(c), the FDIC must be appointed as a receiver in the case of any insured national bank. The determination of insolvency is independent of the executive branch. Notwithstanding the broad language in 12 U.S.C. s. 191, the courts have refused to interfere with the determination by the COC that a nationally chartered institution is insolvent, and thus there is no accepted judicially declared definition of insolvency. The courts, to the extent that they have commented on the issue, are divided. Some apply the balance sheet test in which the bank's assets are compared to its liabilities, while others apply a liquidity test in which the ability of the bank to meet its obligations as they become due is the determining factor. Even where a balance sheet test is applied, considerable debate rages in the United States as to the appropriate valuation procedure for individual loans, and whether loans should be valued on the basis of their book value or market value in light of current interest rates. In the Franklin National Bank failure, the COC depreciated securities and municipal bonds to their market value based on the current depressed stock and bond markets in 1974.

b. The Federal Reserve System

The Federal Reserve Board was created by the *Federal Reserve Act* in 1913 to carry out monetary policy, central banking functions generally, and to improve the supervision of banking. It is said to be an agency "independent within government" in the sense that decisions of the FRB do not have to be ratified by the President or the Executive Branch of government. The FRB reports to Congress.

The FRB consists of the Secretary of the Treasury, the Comptroller of the Currency, and five members appointed by the President and confirmed by the Senate for a term of fourteen years. Two FRB members are designated by the President, with Senate consent, to serve four-year terms as Chairman and Vice-Chairman. The appointments to the Board of Governors are made "having due regard to the fair representation of financial, commercial, industrial and agricultural interests as well as to geographical divisions of the country". The Board is assisted in its deliberations by the Federal Advisory Council consisting of representatives of each Federal Reserve District, and by the Federal Open Market Committee through which the Federal Reserve buys and sells securities, and thus influences the supply of money in the market.

The country is divided into twelve districts, and a Federal Reserve Bank is established by the Board of Governors in each district. The twelve Federal Reserve Banks operate with their own boards of nine outside directors, staffs, and budgets as relatively autonomous entities subject to policies set by the FRB. Every nationally chartered bank is required to be a member of the Federal Reserve Bank in the geographical district within which the member bank engages in banking activities (12 U.S.C. s.222), and under 12 U.S.C. s.321, any state chartered bank may apply for membership as well. The Federal Reserve Bank carries out direct supervisory functions only over state-member banks. Under 12 U.S.C. 24, all state-member banks are required to comply with the reserve and capital requirements of the *Federal Reserve Act*, and must make reports of condition and of payments of dividends to the Federal Reserve Bank of which they are a member. The reports of condition must contain the information required by the Board of Governors.

To carry out their supervisory and regulatory responsibilities, the Federal Reserve Banks employ approximately 1,300 examiners and 600 regulatory officers. The FRB does not receive appropriations from Congress. Nor does it impose examination fees. Rather, the FRB receives its income from assessments on the twelve Federal Reserve Banks. The main source of income of the Federal Reserve Banks is the interest earned on their proportionate share of the Federal Reserve System's holding of securities acquired through open market operations. To a lesser extent, the Federal Reserve Banks receive their income from interest on the Federal Reserve System's holdings of foreign currencies, from interest on loans to depository institutions and from fees for services to various depository institutions. At the end of 1984, 5,983 banks were members of the Federal Reserve System, including approximately 1,000 state-member banks which the FRB examines. The 1986 budget of the FRB provides for $194M (U.S.) for supervision and regulation of financial institutions, compared with $175.1M (U.S.) in 1985. In 1985, the Board and Banks conducted an estimated 750 examinations of state-member banks, 1,600 inspections of bank holding companies, and 2,300 reviews of bank holding company examinations. Under 12 U.S.C. s. 326, the Federal Reserve Bank may rely upon examinations and reports of state authorities in lieu of examinations made by examiners approved or selected by the Board of Governors. In all cases, the FRB can demand that special examinations be conducted.

Liquidity support is provided to both FRB member banks, and since 1980, to "non-member" banks as well, by the Federal Reserve Bank having jurisdiction, under 12 U.S.C. ss. 347, 347 (a) and 347 (b), and under rules and regulations prescribed by the Board of Governors of the Federal Reserve System. Liquidity support is extended either through direct advances secured by "acceptable" collateral, or through the discount of paper meeting the requirements specified in the *Federal Reserve Act*. Short-term adjustment credit is provided directly by each Federal Reserve Bank to member and nonmember banks in each FRB jurisdiction. Extended credit is provided through the Federal Reserve System as "seasonal", "other extended", or "emergency" credit. "Seasonal" credit is provided by the Federal Reserve Bank to institutions experiencing temporary seasonal demands for credit which the Federal Reserve Bank considers will persist for at least four weeks. "Other extended credit" is available where assistance is not available from special industry lenders, and in exceptional circumstances, including sustained deposit drains, impaired access to money market funds, and sudden deterioration in loan repayment performance. Finally, "emergency credit" is available from Federal Reserve Banks, after consultation with the Board, to nondepository institutions where credit is not available from other sources, and failure to obtain credit would adversely affect the economy.

c. *The Federal Deposit Insurance Corporation*

The FDIC was established in 1933 by amendments to the *Federal Reserve Act*, and in 1950, the *Federal Deposit Insurance Act* conferred entirely separate status on the FDIC. The FDIC was created to insure small depositors against losses resulting from bank failures and was given supervisory responsibility to assess the financial risks to which it is exposed. Single depositors are presently protected up to $100,000 (U.S.). The FDIC is an independent agency of the federal government. Management of the agency is vested in a three-member Board of Directors, one of whom, by law, is the COC. The remaining two members are appointed for six-year terms by the President, subject to Senate confirmation.

The FDIC's regulatory powers are set out in 12 U.S.C. ss.1811 *et seq*. Under 12 U.S.C. ss.222 and 1814(b), all nationally chartered members and state banks which are members of the Federal Reserve System must be members of the FDIC. State nonmember banks can apply for FDIC membership. Nationally chartered member banks are automatically accepted into the FDIC upon certification by the COC, and state member banks are admitted upon certification by the Board of Governors of the Federal Reserve System. State nonmember banks are admitted into the FDIC by the FDIC Board only after consideration by the Board of their financial history and conditions, the adequacy of their capital structure, their future earnings prospects, the general character of management, and the convenience and needs of the community to be served by the bank. Certification by the COC in the case of national member banks, and by the Board of Governors of the FRB is based on the same criteria.

The FDIC is based in Washington but conducts its supervisory activities through ten regional bank supervision offices (which are to be consolidated into six by February 1988) and a greater number of sub-offices. The FDIC directly supervises and regulates only insured state nonmember banks such as the Westlands Bank. Under 12 U.S.C. s. 1817(a) only these banks must make reports of condition to the FDIC. However, the FDIC has access to reports of examinations and reports of condition made to the COC and to any Federal Reserve Bank, and the COC and FRB must, under 12 U.S.C. s. 1817 (a)(2)(A), advise the FDIC of any revisions or changes in respect of deposit liabilities made in any report of condition.

To carry out its examination activities the FDIC had approximately 1,500 examiners who examined approximately 8,850 state nonmember banks in 1984. The Division of Bank Supervision (DBS) of the FDIC has shifted its resources from examining all banks and focuses its attention on problem institutions. In 1984, the DBS conducted 9,751 examinations, compared to 17,886 in 1982. The FDIC is self-sustaining, being financed by annual assessments on the banks it insures, at a basic assessment rate of 1/12 of one per cent of total assessable deposits. This assessment usually provides a surplus over operating expenses and insurance losses. A percentage of any surplus is credited to the assessed banks. The losses and expenses sustained by the FDIC in 1984 resulted in an assessment credit of $67.5M (U.S.), compared to $164M (U.S.) in 1983. The 1984 credit represented an effective assessment rate to banks of 1/12.5 of one per cent of assessable deposits, compared to 1/14 of one per cent in 1983.

The FDIC's enforcement powers, enumerated in 12 U.S.C. ss. 1818 *et seq.*, include:

a) termination of insurance where the Board finds that an insured bank is engaged in unsafe or unsound practices, or is in an unsafe or unsound condition, or has violated any applicable law, rule, regulation or order;

b) issuance of cease and desist orders;

c) suspension or removal of directors or officers; and

d) imposition of monetary penalties on the bank or bank officials.

Termination of insurance is employed only rarely. It effectively results in termination of a state bank's membership in the Federal

Reserve System, and in the case of a national member bank, in the appointment of the FDIC as receiver by the COC under 12 U.S.C. s. 1818 (o). The liquidation functions of the FDIC are carried out pursuant to its mandate as a receiver of insured national banks. The FDIC may choose to act as a receiver in the case of insured state banks.

A considerable percentage of the FDIC regulatory function consists of liquidation activities. Examiners detailed to perform liquidation activities gave a total of 352,000 hours to this effort in 1984 compared to 70,000 hours in 1982. At the end of 1984, the Liquidation Division held assets with a book value of $10.33B (U.S.). The Liquidation Division is currently expanding its staff, and has developed a centralized liquidation asset management information system which will support collection activity, loan servicing, loan delinquency analysis, and loan market analysis.

The FDIC is also empowered to purchase assets from, make deposits in, or extend loans to any insured banks which have closed or are approaching failure, and may make loans, purchase assets, or issue guarantees to help an insured bank assume a failed or failing insured bank. Finally, the FDIC may create "deposit insurance national banks" to provide limited banking services to ease difficulties for depositors in communities where banks have failed. The FDIC established such a bank in the case of the Penn Square Bank failure, and in 1983, sold the remaining deposits in that bank to Charter National Bank. The power to create a deposit insurance national bank is rarely exercised, as in most communities, existing alternate banks are available to provide depositors with replacement banking services.

The FDIC exercises a range of powers once it determines that a banking institution will not survive without active intervention. These include deposit payout procedures in which the FDIC simply closes the bank and pays off insured depositors under 12 U.S.C. s. 1821(f), purchase and assumption arrangements under 12 U.S.C. s. 1823(c)(2) in which the FDIC effectively insures all deposits by arranging for a merger or a consolidation with another bank (thereby recovering the "going concern" value of the bank), and deposit transfers in which insured deposits are transferred to a healthy insured bank and in which the FDIC will sometimes make an advance payment of funds to uninsured depositors and creditors of the failed bank. Neither the Federal Reserve nor the COC has the explicit statutory authority to supervise and manage a failing bank in the manners available to the FDIC.

Finally, the FDIC can exercise authority to take an assignment of the bank's assets, including the bank's right of action against its directors and officers. Under 12 U.S.C. s. 1821(d), the FDIC has a statutory duty to enforce the individual liability of stock holders and directors. As one U.S. commentator stated, "in almost every bank failure case, suits are brought by the FDIC against various officers and directors". In addition, under 12 U.S.C. s. 1821(g), the FDIC upon payment to any depositor is subrogated to the depositors' rights against the bank.

d. Other Regulatory Authorities

As noted earlier, there are two other federal agencies which exercise regulatory responsibilities over commercial banks: the Securities and Exchange Commission (SEC) and the Anti-Trust Division of the Department of Justice. Neither the SEC nor the Anti-Trust Division has an examination role akin to that of the three other federal bank regulatory bodies. The Anti-Trust Division enforces anti-trust laws which may be offended by mergers and acquisitions in the banking community.

The banks are "regulated" in a sense by the SEC. Under 15 U.S.C. s.78l(h), regulatory authority over the issuance of securities by a FDIC insured bank or by a Federal Savings and Loan Corporation Act bank is vested in the COC for nationally chartered banks, in the Board of Governors of the Federal Reserve System for Federal Reserve member banks, and in the FDIC and Federal Home Loan Bank Board for FDIC and FSLIC insured banks, respectively. The COC, Board of Governors, FDIC, and FHLB are directed to issue substantially similar regulations to those issued by the SEC under the *Securities Exchange Act, 1934*, but under 12 U.S.C. s.78(l)(h) and s.78(l)(i), the bank regulators may use disclosure standards different from those used by the SEC.

The SEC does, however, directly supervise the issuance and trading of securities by bank holding companies. Under 12 U.S.C. s. 78(g)(i), "every issuer" must register securities with the SEC. The Bank holding companies are included in the definition of issuer.

Finally, the SEC can enforce the anti-manipulative provisions of the *Securities Exchange Act*, can suspend trading in bank securities, and is authorized to investigate the activities of banks and banking officials who may have disseminated false and misleading information about the bank's financial condition.

3. The System of Supervision in the United States

The three U.S. federal agencies rely on intensive systems administered by their own staffs whereas the systems of the United Kingdom and Canada may be characterized, by comparison with the U.S. approach, as flexible and passive.

The COC, FRB, and FDIC have very similar systems of supervision. The tools used in each system are essentially of four kinds: prudential returns ("reports"), examinations and other visits to banks, computer-based surveillance systems that process and analyze data as received, and regulatory enforcement tools.

The "Reports of Conditions" from the banks are an essential tool. All commercial banks provide the regulators with a wide variety of prescribed regular reports, usually on a quarterly basis. The information obtained in most of the reports has a direct bearing on matters of safety and soundness, but some reports are designed to provide information to assist in evaluating the general economic condition of the nation.

The principal reports, known as "call reports", indicate financial condition and income on a quarterly basis. The form of the call reports is uniform among the three federal agencies. The report of condition consists of the balance sheet of the bank, with further details touching upon matters such as past due, nonaccrual, and renegotiated loans. The report of income includes detailed information about income, expenses, changes in equity capital, changes in allowances for loan losses, and tax liability. The data in the call reports are analyzed systematically by regulators, used to monitor the condition of the bank between on-site examinations, and stored on computer for future surveillance purposes. The contents of the reports are not audited but are certified as accurate by officers of the bank submitting them. The reports of condition and income are public records.

The second tool is the on-site examination, carried out by anywhere from four to twenty or more members of the specially trained staffs of examiners of the relevant agency. None of the federal bank agencies relies on work that may be conducted by a bank's external auditors. Where audits are conducted, the examiners may obtain the results for additional information purposes only. This lack of significant interplay between the supervisors and the external auditors is by design. Examiners consider that the work of auditors is of limited value as it focuses on audit controls, the financial reporting system of a bank, and whether the accounts adhere to accepted accounting principles rather than on a detailed assessment of the quality of the bank's assets and management. A qualitative assessment is essential to a measurement of safety and soundness.

Commercial banks may be subject to different kinds of examinations. The principal examination is for purposes of determining safety and soundness. Generally speaking, the safety and soundness examination covers asset quality, the nature of liabilities, liquidity, earnings, capital adequacy, bank management and controls, policies, procedures, accounting practices, and insurance. Separate examinations are often conducted to determine compliance with consumer or civil rights legislation and laws of general applicability, or to confirm the soundness of trust departments, the quality of data processing facilities, and so forth. Examiners have designed a grading system for loan quality. Inferior assets may be classified as "other assets especially mentioned", "substandard", "doubtful" and, for the worst loans, "loss". This classification system assists the regulators in formulating directives to the examined bank to change practices, increase loss provisions, or to take other action as required.

A safety and soundness examination may be a "full scope" or "modified" examination. The full scope examination involves a more complete diagnosis of a bank's loan portfolio, including items such as past due loans, loans previously classified, and the quality of the underlying security. The modified examination is abbreviated and tailored to the bank's size and complexity. Examiners conducting a modified examination generally direct their attention to the adequacy of a bank's internal control measures rather than to a detailed sampling of assets. The modified examination is used only for banks which are regarded as having a good record of financial condition.

The frequency of safety and soundness examinations varies across the different agencies according to resources and the anticipated financial condition of a bank. For example, the FRB seems to examine state member banks every 18 months, except where weaknesses require more frequent visitations. In the case of a well-regarded bank, the Division of Bank Supervision of the FDIC may go four or five years between examinations, although state regulators may examine the same bank more frequently. Problem banks may be examined by the FDIC several times a year.

A safety and soundness examination results in a comprehensive bank report that is analyzed by regulatory authorities beyond the examiner level and forms the basis of discussion between the examiners and the bank management and board of directors. Since 1978, a safety and soundness examination also results in ratings under the Uniform Interagency Bank Rating System which has been adopted by both federal and state agencies. These ratings provide a succinct assessment of the examined bank's level of safety and soundness as part of the comprehensive bank report. Examiners initially rate banks in the five different categories which make up the CAMEL system (for capital, assets, management, earnings, and liquidity). On the basis of ratings in these categories, the examiners then give to the bank an overall rating, on a scale of 1 to 5. In this overall rating, a 1 or 2 indicates that the bank is favourably regarded by the examiners. A 3 indicates that the bank is in a state which is marginally unsatisfactory. A rating of 4 or 5 indicates that the bank is fundamentally unsound, with 5 warranting immediate corrective measures to avert probable failure. As a bank's ratings deteriorate it is more closely watched by the supervisors, and appropriate steps are taken to restore its strength. These ratings are not publicly disclosed. In 1984, about 800 banks were identified by the FDIC as "problem" banks, with CAMEL ratings of 4 or 5. The numbers have grown steadily since 1981.

The third tool is the surveillance programs operated by the three main federal bank regulatory agencies. These are computer-assisted monitoring systems that permit the regulators to follow changes and trends in the financial condition of supervised banks and their holding companies. Data collected through the reporting and examination processes are gathered and entered into the agencies' computers, and used to produce a variety of statistics and financial analyses which in turn will give early notice of deteriorating conditions in a bank. Where problems are perceived to be developing, examinations of the troubled institution are increased accordingly. Where no problems are perceived or where trends do not show the signs of developing troubles and the bank has a good financial history, examinations may be deferred and the resources of the agency reallocated to institutions requiring closer scrutiny. As the cost of electronic data processing systems has declined, and the world of banking has become more complex, U.S. federal agencies have found their surveillance program to be an increasingly cost-effective supervisory practice.

The last tool of the supervisor consists of a series of enforcement procedures. As might well be expected in a banking system with 14,463 commercial banks, bank examinations in the United States frequently turn up troubled institutions. The troubles may have arisen for a number of reasons but generally reflect unsafe or illegal practices. Illegal practices will usually give rise to criminal prosecutions, and are dealt with by law enforcement authorities. Where practices are unsafe, the COC, FRB, and FDIC possess a variety of enforcement powers to rectify weaknesses or, in extreme cases, to close a bank. These include informal discussions, memoranda of understanding, cease and desist orders, civil money penalties, suspension and removal powers, termination of insurance by the FDIC, and revocation of a banking charter by the COC or state chartering agency, or revocation of membership in the Federal Reserve by the Board of Governors of the Federal Reserve System.

Informal discussions provide the obvious treatment for minor difficulties. Where examinations reveal that a bank's problems leave it in a marginally unsatisfactory condition, the regulatory agencies may wish to obtain a written assurance from the bank that unsafe practices will be stopped and specific corrective measures will be taken. Obtaining written assurances in a memorandum of understanding is a final step before formal procedures are used. Where a bank refuses to provide such a memorandum, or where the regulator determines that more prescriptive measures are warranted to correct specific situations, cease and desist orders may be issued. The regulatory agencies have the power, in extreme cases, to issue temporary orders which have immediate effect, but which only become permanent after subsequent administrative procedures.

Generally speaking, the practice is that the regulator issues and serves a notice of charges or violations of laws, rules, regulations, or any conditions imposed in writing by the regulator. The notice contains a statement of the facts constituting the alleged violation or unsound practice and fixes a time (not sooner than 30 days or later than 60 days) and place for a hearing (usually, but not necessarily, private) to determine whether an order to cease and desist should issue against the bank, or any individual participating in the affairs of a bank. Parties failing to appear are deemed to consent to the issuance of the cease and desist order. Where there is consent or where, at the hearing, the agency finds that the charge is established, the agency may issue and serve a cease and desist order. Such orders typically require the termination of violations or unsound practices or to take corrective action, and are effective 30 days after the order is served.

Any party subject to an order may obtain judicial review of the order. The start of proceedings for judicial review does not, unless specifically ordered by the court, operate to stay the cease and desist order. The review proceedings are public and subject to further appeal.

In the case of the FDIC, cease and desist orders are an integral tool of enforcement with important advantages over the more extreme power to terminate insurance and the more lenient power to require memoranda of understanding. These orders create a legal requirement for positive action, may be confined to particular problems, can be used promptly, and are less cumbersome to enforce than the extreme power of termination.

Agencies may remove or suspend bank executives or directors where their action or inaction can be shown to have jeopardized the safety or soundness of the bank. They may also impose money penalties on banks or bankers for failure to abide by various rules, regulations or cease and desist orders. Civil money penalties are open to judicial review.

The remaining powers of the agencies are the most severe. Termination of insurance benefits, revocation of a charter by the COC or revocation of membership in the Federal Reserve System effectively end the operations of a bank. Loss of deposit insurance automatically follows loss of Federal Reserve System membership and effectively closes a bank. In view of the severity of these powers, and the accompanying procedural safeguards, regulators use them only in extreme cases. Nevertheless, their existence lends considerable strength to the instructions of the regulatory agency.

In 1985, the FDIC issued 186 cease and desist orders, down from 223 in 1983 but up from 138 in 1984. Forty-six civil money penalties were levied in 1985, representing a dramatic increase from the 14 and 12 levied in 1983 and 1984 respectively. During 1985, 37 removal or suspension proceedings were carried out compared with 13 such proceedings in 1984 and 9 in 1983. In 1985, the FDIC initiated 75 termination of insurance proceedings, which brought to 414 the number of times the power has been used since 1933. In the majority of these cases, the banks involved corrected their problems, were absorbed by other banks or closed before insurance was actually terminated.

The COC issued 154 cease and desist orders in 1985, compared with 99 in 1984. In 1985, 11 temporary cease and desist orders were issued compared with 9 in 1984. Two hundred and two civil money penalties were issued in 1985, a substantial increase over the 109 and 127 issued in 1984 and 1983 respectively. The COC used its suspension or removal powers on 19 occasions in 1985, 20 in 1984, and 4 in 1983. There have been no revocations of charters.

The Board of Governors and the Federal Reserve Banks completed 144 formal enforcement actions in 1985. In connection with these formal enforcement actions, the Board of Governors issued 79 cease and desist orders and 13 temporary cease and desist orders. The figures for 1984 show 80 completed actions with 22 cease and desist orders and 4 temporary cease and desist orders having been issued. The FRB entered into 98 written agreements in 1985, up from 60 in 1984. In 1985, there were 3 orders of suspension against individuals and 11 permanent removal or prohibition orders against individuals compared with 2 orders of suspension and 8 permanent removal or prohibition orders in 1984. Lastly, these statistics of the FRB show that in 1985, $46,000 (U.S.) in civil money penalties was collected from 14 individuals, and $1,000 (U.S.) from one company. Apparently, a further $50,000 (U.S.)

penalty against one individual was assessed in 1985 but is not yet collected. In 1984, $37,002 (U.S.) in penalties were collected from one bank, two bank holding companies, and 20 individuals.

4. The Continental Illinois Assistance Program

In the late winter of 1984, the FDIC, acting pursuant to 12 U.S.C. s.1832(c)(2), determined "in its sole discretion" that the Continental Illinois should receive assistance as it was either in danger of closing, or required assistance because of "severe financial conditions which threatened the stability of a significant number of insured banks possessing significant financial resources". The interim financial aid package announced on 17 May 1984, and authorized by 12 U.S.C. s.1823(c)(2), consisted of a $5.3B (U.S.) unsecured line of credit from 24 banks, a $2B (U.S.) subordinated demand loan from the FDIC, a promise by the FRB to meet "extraordinary liquidity requirements", and an FDIC guarantee that all depositors and general creditors would be fully protected. Over the course of the following months, the FDIC, FRB, and COC attempted, unsuccessfully, to arrange a merger of the Continental Illinois, and, in July 1984, announced a permanent assistance program.

The creation of a permanent assistance program is dependant upon a preliminary determination that a bank is "essential". Under 12 U.S.C. s.1823(c)(4)(A), the FDIC has virtually unconstrained discretion to determine that a failing bank's continued existence is "essential to provide adequate banking services in its community", and thus should receive financial assistance from the FDIC. There is nothing in the section which indicates which factors should be considered by the FDIC in its determination of essentiality. Apparently, the FDIC in the Continental Illinois case relied upon a range of factors including the size of the bank, the impact of the bank's failure would have on other banks with uninsured deposits and on correspondent banks, and the impact that the effects of the failure on international and domestic money markets.

Upon a determination of essentiality, the FDIC may render any assistance under s. 1823(c)(1) and (2), and is not restricted to an amount necessary to save the cost of liquidating. In the case of the Continental Illinois, the FDIC, together with the FRB and COC, announced a permanent assistance program consisting of:

(a) The purchase for $2B (U.S.) of Continental Illinois problem loans by the FDIC with a book value of $3B (U.S.). Payment for the loans was made by assumption by the FDIC of $2B

(U.S.) of Federal Reserve loans to Continental Illinois. The FDIC will repay the Federal Reserve loans with the proceeds of the purchased loans (which will be managed by Continental Illinois under a servicing contract with the FDIC), and will make up the deficiency, if any, from its own funds on maturity of the borrowings.

(b) An additional $1.5B (U.S.) of Federal Reserve borrowings was assumed by the FDIC in consideration of a promissory note in the amount of $1.5B from the bank. The bank has the option to repay the note by selling up to $1.5B (U.S.) of Continental Illinois loans outstanding on 31 May 1984 to the FDIC for book value. The option expires in three years. The FDIC is obliged to pay the Federal Reserve borrowings.

(c) The purchase of $1B (U.S.) of newly authorized nonvoting preferred shares of the Continental Illinois Corporation (CIC), the Bank's holding company. This amount would be down-streamed to Continental Illinois. The newly authorized shares consisted of:

    (i) $720M (U.S.) of convertible preferred shares, convertible upon sale or transfer by the FDIC into 160 million common shares of the CIC representing 80 per cent of the capital of the holding company; and

    (ii) $280M (U.S.) in adjustable rate, cumulative, preferred shares, callable at the option of CIC.

(d) The creation of a new holding company by the original shareholders of the CIC, the transfer of the $40M (U.S.) CIC shares owned entirely by the original CIC shareholders, who approved the plan at a special meeting on September 26 1984, to the new holding company.

(e) The granting of an option to FDIC to acquire up to 40.3 million shares of CIC held by the new holding company. It may be exercised at the price of $0.00001 per share in the event of a net loss to FDIC after 5 years on the loan purchase arrangements, at a rate of 1 share per $20 (U.S.) of loss.

(f) An agreement to return all remaining assets to the bank if the FDIC does not suffer any losses on the loan purchase arrangement.

(g) A restriction on the payment of dividends by the new corporation until final settlement with the FDIC. Any dividends received by the new corporation on its $40M (U.S.) share investment in CIC will be available to cover potential FDIC losses.

(h) The creation of a rights offering, to current CIC shareholders, consisting of 40 million shares of CIC at $4.50 (U.S.) per share within 60 days, or $6.00 (U.S.) per share within a subsequent 22 month period, the proceeds of which will be downstreamed to the bank.

(i) The continuation of the assurance given by the FDIC that all depositors and other creditors will be fully protected.

(j) The continuation of the FRB assurance that it will meet any extraordinary liquidity requirements of the bank.

(k) The continuation of the $5.3B (U.S.) line of credit provided by a group of major banks.

(l) The assignment to the FDIC by the bank of all claims against officers, directors, employees, accounting firms, and the like, arising out of any act or omission occurring prior to the permanent assistance package.

(m) The Boards of the CIC and the bank named two new executive officers.

It should be noted that the Federal Reserve and the FDIC have been severely criticized for the actions taken in connection with the Continental Illinois Assistance Program. The justification for the determination of "essentiality" under 12 U.S.C. s.1823(c)(4)(A), the absence of a written record to justify the FDIC decision to establish the temporary assistance program, the accuracy of FDIC assessments of the impact on other banks of the bank's failure, the decision, through the FDIC purchase of stock in the holding company, to take a subordinated position to $1.1B (U.S.) in long term debt, instead of purchasing debentures from the bank directly, and the failure of the FDIC to consult the Treasury prior to its involvement in the program, have all been cited as raising substantial questions regarding the authority and propriety of FDIC actions.

5. Public Disclosure of Cease and Desist Orders in the United States

Students of bank regulation in the United States have recently turned their attention to market discipline and its prerequisite, public disclosure, as a supplement to confidential bank supervision. Their experience and proposals are helpful in considering the complex issue of whether the cease and refrain order, recommended in Chapter 6, should be disclosed to the public.

The SEC does not directly regulate bank securities because banks are exempt from SEC jurisdiction under s.12(1) of the *Securities Exchange Act*. The SEC does, however, regulate bank holding companies which fall under the general definition of "issuer" in the Act. D.L. Goelzer, General Counsel of the Securities and Exchange Commission, in a presentation made in late 1985, described the position of the SEC regarding disclosure of bank regulatory action. According to him, an examination report, which remains the property of the bank regulatory authority, generally may not be disclosed to third parties, or to the public, by the financial institution. Disclosure is prohibited by regulations of the COC, the Federal Reserve, and the FDIC. As a result of its examination, the bank regulator may take further action, including an informal agreement, a formal agreement, a cease and desist order, or an undertaking. The existence of such items may be material to investors in the financial institution or its parent holding company, depending on the nature of the item. The conditions or practices cited in the examination report, or giving rise to the action by the regulatory authority, may also be material to investors. The underlying conditions and practices, the regulatory action, and any consequent undertakings may have to be disclosed in filings with the SEC under a rule which requires that registrants include in their filings "such further material as is necessary to make the required statements, in light of the circumstances under which they were made, not misleading." In the past, some holding companies have not made disclosure of such facts or events with respect to themselves or their subsidiary bank, on the ground that confidential examination reports must not be disclosed. The SEC, on the other hand, takes the view that information originating at the financial institution about such conditions in the bank exists independently of the confidential examination report. If such information is material, it must be disclosed. The case law in the U.S. courts tends to support that view.

Thus, in summary, it can be stated that the SEC expects disclosure of the existence of cease and desist orders, conditions and practices cited in examination reports, and undertakings given to the regulators relating to the condition of a bank where they are material to investors in bank holding companies. While examination reports may be confidential, the information contained in them, of which the bank must know independently, therefore, must be disclosed.

The federal bank regulators themselves have adopted a similar attitude in their disclosure policies. An example is the FDIC. According to a 1985 FDIC Statement of Policy published in the U.S. Federal Register, insured state nonmember banks that are subject to orders resulting from statutory enforcement actions are presently required by FDIC regulations or policies to disclose this fact to the public in certain circumstances. Banks with securities registered with the FDIC in accordance with the *Securities Exchange Act of 1934* are required to inform investors of the issuance of the final orders in documents such as annual reports, quarterly reports, current reports, and proxy statements. Banks seeking to raise capital (debt or equity) through a public offering, whether or not their securities are registered, are expected to disclose the existence of enforcement actions in offering circulars prepared for distribution to potential purchasers. In addition, beginning in late 1984, all cease and desist orders issued by the FDIC have contained a provision requiring the bank to provide a description of the order to its shareholders in conjunction with the bank's next shareholder communication and with its notice or proxy statement preceding the next shareholders' meeting. In circumstances other than these, information concerning a statutory enforcement action against a particular insured state nonmember bank has generally not been made available. However, this is subject to two exceptions. The FDIC will release a copy of a final order issued against a specific bank or individual when such a document is requested under the *Freedom of Information Act*. As well, should the final administrative order be subject to judicial review, its existence will be disclosed through the ordinary hearing in open court.

In mid-1985, the FDIC proposed to issue new guidelines. Considering that its existing disclosure procedure was an inefficient method for insuring that all market participants are equally aware of statutory enforcement actions taken against a bank, and desiring greater public scrutiny of activities of the banks and individual bank officers, the FDIC proposed that it would publish and make available to the public, by way of FDIC press release, the names of all banks and persons participating in their affairs to whom the FDIC has issued orders in conjunction with formal enforcement actions. The policy would apply to insurance termination orders, cease and desist orders, removal orders, suspension orders, civil money penalty orders, and capital directives. The policy was not proposed to extend to notices issued by the FDIC to banks and persons participating in their affairs to initiate administrative proceedings, and other lower forms of administrative law life such as memoranda of understanding with the FDIC. The proposals were withdrawn in June 1985. The FDIC received vigourous and varying comments on its proposal, which perhaps had led them to the conclusion that further study was necessary. Hence, while the FDIC is still considering the role of market disclosure in bank regulation generally, it has decided that the existence of final orders must be disclosed in shareholder communications.

In late 1985, the COC published a series of proposed rules for comment regarding disclosure of financial and other information by national banks. Included within the proposal was a requirement for banks to disclose any administrative action taken by the COC which during the fiscal year resulted in a cease and desist order, formal agreement, memorandum of understanding, civil money penalty, removal order, capital directive or other form of administrative action against the bank, any of its officers, directors, employees, agents or any person participating in the affairs of the bank. The bank would be required to summarize and disclose the facts and circumstances resulting in the administrative action taken by the COC, the result of that action, and any remedial steps taken by the bank. In addition, the bank would be required to state whether, during the year, the COC had issued any notice of administrative action not included in the foregoing. This would, therefore, include any notice of charges against the bank, notice of assessment of civil money penalty, or notice of suspension or removal of a director or officer. Similar disclosure requirements would apply to quarterly reports. In addition to the specific disclosure items, there would be a general requirement that periodic reports contain any material information required to make the reports not misleading in light of the circumstances under which they are made. The term "material" would reflect the broad class of persons intended to benefit from the disclosure requirements of the proposal, and the test of materiality would cover information about matters of which an average prudent depositor or investor should reasonably be informed. It is interesting to note that the COC is considering, but has not made proposals about, further new disclosure methods. Among other things, the COC is considering whether disclosure of composite or individual CAMEL ratings assigned to national banks would provide useful supervisory information to bank management. The COC noted in its proposal that, should it determine to disclose such information to banks, it would be necessary to consider collateral public disclosure issues raised by these actions, including whether CAMEL ratings should be publicly disclosed, or must be disclosed, under the federal securities laws.

Thus it must be concluded that the regulatory authorities both in banking and securities have recently turned their attention to the usefulness of the discipline of public disclosure as an aid to bank surveillance. The system has for years been a compromise between prudential confidential supervision to ensure the integrity of banks as institutions, and investor and depositor protection through awareness of matters material to the risk assessment process. The watershed has shifted over the years and this process of balancing will continue. All this should be instructive for those concerned with these same issues in Canada.

6. Proposed Changes to U.S. Bank Supervision

The current position in the United States and proposed changes to that position in relation to public disclosure of administrative orders has been briefly discussed in the last section. It is axiomatic that public disclosure of a bank's financial condition is not the cause of that condition. It has been argued that increased disclosure may result in a rapid deterioration of its financial condition, and liquidation. It would appear to have been demonstrated in the last decade in the United States by the experiments in public disclosure, that the market discipline model represents no "panacea for the ills of the banking system". Disclosure as practised in the United States is at most a reasonably satisfactory balance between the need to protect investors by disclosure on the part of banks, and the need to protect depositors and the general public through confidential supervision. Nor has the aggressive system of banking supervision used in the United States eliminated bank failures. In fact, in the last several years, the U.S. banking system has experienced some of the largest failures and near failures in its history. This year alone, to 26 March 1986, there were 13 state commercial bank failures and 8 national bank failures. In 1985, there were 88 state commercial bank failures and 30 national bank failures; a substantial increase over the failures which occurred in 1984.

These failures have led to various recommendations for improvements to the supervisory system. The General Accounting Office in the United States has made numerous studies of the federal supervision system, and has acted as a catalyst for change. So too have the federal regulatory agencies themselves. The report of the Bush Task Group recommended changes at the systemic level rather than alteration of existing supervisory practices. The Task Group suggested measures to reduce excessive regulation, to eliminate overlap in agency responsibility, and to control escalating costs. Apparently, the particular measures proposed by the Task Group have been received with limited enthusiasm although there is agreement with its general conclusion that any modification of the regulatory system should have as its aims increasing competition among providers of financial services and reducing regulatory burdens that hinder the efficient provision of those services.

C. CONCLUSION

This brief review has focused upon the national system of bank supervision in the United States and the United Kingdom.

In the United States, unlike the United Kingdom, there is no concerted movement to make fundamental changes to existing supervisory practices which are regarded, generally, as satisfactory. One witness summed up this general satisfaction when he stated: "We obviously do not like bank failures. We try to prevent them if we can, but we do not regard a certain number of failures as being necessarily an indictment of the supervisory system".

The financial system in the United States is much larger and much more complex than that found in Canada. The detailed regulation that has built up around this financial system has become enormously expensive and, according to the Task Group, inefficient in many ways. The regulatory web in the United States also appears to have had a more insidious consequence: it has created financial institutions which often respond only to the precise demands of the letter rather than the spirit of the law, and has reduced the element of "self-regulation" to virtual extinction. What in other jurisdictions is seen as a working team of operator and regulator, has become, at least in the case of less substantial banks, an adversarial competition between the two.

Appendix C

Formation and Evolution of Canadian Commercial Bank

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Appendix C

Formation and Evolution of Canadian Commercial Bank

A. BACKGROUND AND INTRODUCTION

For many years prior to the creation of the Bank of British Columbia in 1967, the Canadian banking system was dominated by a small number of national banks with head offices in Eastern Canada. Generally, these banks were prosperous and stable. They developed diversified loan portfolios and enjoyed favourable economic conditions following the Second World War.

There was a concern in the 1960s that these large banks were not responsive to the economic needs of the western provinces. In July 1973, the Federal Government hosted the Western Economic Opportunities Conference in Calgary. The proceedings indicated a general perception that the banking industry had not served the economic needs of Western Canada effectively, and that western-based banks would be more responsive to the needs of residents of the region. The experience of the Bank of British Columbia was used to demonstrate that a western-based bank could be financially successful.

B. THE ORIGINAL CONCEPT FOR THE CCB

In the summer of 1973, the senior executives of Morguard Trust Company, through Boyd, Stott & McDonald Ltd., a merchant banking affiliate of Morguard, developed the concept on which the CCB was based. On 30 July 1975, Parliament granted a charter to incorporate the Canadian Commercial and Industrial Bank. In 1981, the name was changed to the Canadian Commercial Bank under which it carried on business until liquidation.

On the asset side, it was not contemplated that the bank would compete with the large chartered banks; rather, the target clients were members of the commercial middle market. These clients were junior industrial companies, privately owned and owner-managed. Such a client generally would not have access to equity markets or other sources of capital. Typically, such businesses would require an operating line of credit, and also a term loan to finance the acquisition of fixed assets, with total borrowing requirements of $500,000 to $10M. The bank saw opportunities in pursuing such clients in the real estate, wholesale, and energy industries.

The original concept for the CCB indicated that the bank had no interest in consumer or retail banking. On the liability side, the bank was to be funded by the wholesale money markets. While this strategy entailed higher funding costs, savings were expected to result from the elimination of a large system of retail deposit-taking branches. The concept of wholesale funding was used by some banks in the United States, and in Canada, the Mercantile Bank was already operating on such a system. The loans to the middle market segment would necessarily involve a higher rate of interest above prime than would major and larger loans to big corporations. In many cases, lending would involve charging fees in addition to the interest rate, in compensation for the time required of the lending officers in tailoring and structuring the loan to the needs of the borrower.

CCB expected to provide merchant banking services. This term refers to bank activities that generated fee income in addition to interest income. Income would arise from acting as a financial intermediary, creating investment vehicles and raising capital for or facilitating the flow of capital into those vehicles. This was to involve the bank in providing financial counselling to its customers on a much greater scale than in the existing banks. It was understood that the CCB concept involved finding an entrepreneurially-minded lending staff; lending officers would be bankers who had an interest in the market segment CCB intended to serve. They would understand business, understand and relate to the entrepreneurs with whom they would be dealing, and be able to give fast responses to lending requests that were necessary in providing the special kind of service to that market segment. It was also part of the CCB concept that the bank was to be capitalized by a small number of shareholders. The shares would be placed privately, and the shareholders were to be for the most part large investors, such as financial institutions, pension funds and locally prominent and wealthy individuals. The bank was to identify with those shareholders, and would utilize them in the marketing of the business.

The fact that CCB would be a business-oriented, specialized bank that would not engage in consumer banking and would be funded by the wholesale money market, and that management of the bank would be aggressive and responsive to the needs of business in each of the areas where CCB would locate, was disclosed in the course of Commons and

Senate hearings relating to the private bill. The sponsors in 1973 retained economists and bankers or former bankers and William Scott, the former Inspector General of Banks who had retired in 1972, to advise in respect of the development of the proposal and its presentation to the various authorities who were responsible for its approval.

The representations made by the original incorporators of CCB in the House of Commons include a statement by the Provisional Chairman of the bank that it is "quite clear that we are wanting to establish a national bank with offices in all the provinces and we want to have an international outlet". These plans, it was stated, were in response to encouragement from the Department of Finance, the Bank of Canada and the Inspector General for the creation of new banks in Canada. The desire for national and international exposure reflected the originators' recognition that regional concentration of operations involved danger both in terms of loan quality and economic downturns. The proposed bank was intended to be an aggressive, low-overhead bank responding to the needs of smaller businesses and not one which would engage in direct competition with the major banks. The type of lending was described in detail by the first Chairman: "I think to the extent that we are going into certain classes of loans in greater volume, there will be a slightly greater risk but there will also be an anticipated greater return, so our risk return ratio will remain in balance." He went on to describe the primary interest of the existing large banks in lending on the strength of credit or covenant of the individual borrower whereas CCB intended to go into the higher risk loans to borrowers without the covenant strength necessary to attract the larger banks. In doing so, he stated, CCB would rely on the security taken. For all this, the CCB would, in their plan, recover a higher return than that received by existing banks. To the Senate Banking and Trade and Commerce Committee, Mr. W.H. McDonald, the first Chairman of the bank, revealed the bank's intention to "buy deposits" on the money markets.

The Inspector General of the day appeared in the Committees of both Houses of Parliament and recorded that he had no objections to the CCB proposals. The applicants were undeterred by the Committee Chairman's observation that there had been approximately 160 chartered banks in Canada most of which had failed or were amalgamated or otherwise rescued by other banks so that "what we have today are the survivors". In the Senate debates, the activities proposed by this new bank were described as unique in that "it will avowedly engage in what it calls 'risk' financing". Indeed, the sponsors of the bill were complimented on their courage in proposing to operate such a bank. In summary, the sponsor, speaking in the Commons, stated that the CCB was to be a business-oriented bank "as distinct from a full service bank". The private bill went through in a short period of time: ten weeks passed from the date of introduction of the private bill until Royal Assent in 1975.

C. ORGANIZATION OF THE CCB

Originally, and as provided in the incorporating statute, the head office was to be located in Vancouver. Before licensing the bank for business, it was realized that the Alberta economy was more buoyant than that of British Columbia, and that there were advantages in Alberta's somewhat more central location. The CCB's Special Act was amended to provide that the head office of the bank would be located in Edmonton. The provisional directors of the bank were J.T. DesBrisay, Q.C., G.H. Eaton, A.V. Hudon, W.H.T. McDonald, W.E. Scott, and G.H. Walker. Eaton became the first Chief Executive Officer of the bank.

Howard Eaton had been with the Bank of America as an officer in the international banking division, with service overseas for 2 years. He then joined an investment firm in Vancouver, and was manager of the money market operations for two years. From August 1969 to January 1974, he was the Executive Vice-President of the Bank of British Columbia, and held similar posts in subsidiaries of that bank. His most recent experience, prior to joining CCB, was as President and Chief Executive Officer of a Vancouver financial company. Eaton was a very significant factor in marketing the concept for the CCB. He was found by DesBrisay, one of the original directors, to be an impressive organizer:

> There is no doubt, just absolutely no doubt that Howard Eaton was an extremely impressive person. He was articulate and he was very confident. He was experienced and, in the days at the very beginning of the bank, his management abilities were apparent. He was a great implementer; he was in total command and we thought we had, and probably did have, a winner.

The authorized capital base of the bank was $40M (par value of shares $10). Subscribed capital amounted to $22M, which was paid in between 17 June 1976 and 1 June 1978, at $11.00 per share. On 17 June 1976 the bank was granted a licence to commence business. By the end of the first fiscal period, the CCB had in place a chief operating officer, a general manager, vice-presidents for regional offices in each of Alberta, British Columbia, Ontario, and Eastern Canada, as well as for international and merchant banking operations. The bank had appointed assistant vice-presidents for asset-liability management, credit and foreign exchange. Other senior officers had been appointed to accounting and control functions.

D. WESTERN CANADIAN DEVELOPMENT AND THE EARLY GROWTH OF CCB

The bank grew quickly in its early years as Table C.1 containing financial highlights demonstrates.

Table C.1

CCB Financial Highlights 1977-82

	1976-77[a]	*1978*	*1979*	*1980*	*1981*	*1982*
			(millions of dollars)			
Total assets	113.3	249.2	504.7	863.6	1,475.3	1,995.5
Total loans	91.59	202	430.8	746.8	1,309.7	1,711.3
Deposits	91.8	218.3	458.7	763.9	1,348.4	1,817.4
Total capital & reserves (*includes surplus*)	16.44	23.3	26.0	55.7	75.5	83.6
Net income	0.279	0.9	2.9	5.6	9.9	8.5

a. First fiscal year end was 31 October 1977.

The early growth of the CCB and of the Northland Bank (described in Appendix E) was fuelled by the western economic boom which was largely led by the Alberta energy sector. Expectations of massive investment in Western Canada grew in the mid-1970s.

By February 1975, the Governments of Alberta and Canada had signed an agreement providing the basis for the successful financing of the first energy mega-project in Alberta, Syncrude. Analysts anticipated this project would generate an income effect of $2.5B in the construction phase, and an income effect of $34B during a 25-year operational phase. By year end 1974, the province had expended $41.5M on Syncrude, while the private sector in the same period expended some $9M in capital, and expected to add $19M to that by the end of 1976.

Syncrude marked a turning point in the energy history of Alberta. Four more such plants were expected by 1991, fuelled by demand projections such as the National Energy Board's 1978 report on Canadian Oil Supply and Requirements, and the Alberta Energy Resources Conservation Board's 1975 report on the application of Alberta Gas Ethylene Company Ltd.

These planned projects spawned considerable activity among smaller oil, construction, and trade companies. Lacking access to equity funding, these companies used short-term demand loans to finance their operations. This pattern was, by 1980, proceeding at a very rapid rate consistent with both private and public projections of requirements, and perceptions of opportunity. This Inquiry heard expert testimony to the effect that, as late as 1981, a prudent member of the Alberta business community would not have foreseen the magnitude of the economic downturn which occurred in 1982. All this must be borne in mind when assessing both the actions taken in the Alberta community, including the banking community, and the economic devastation which befell the region commencing in 1982. During the same period, real property values soared in Alberta. For example, in Cold Lake a 240-fold increase in real property values was experienced in some cases between 1977 and 1980. In downtown Calgary some commercial property values escalated at rates as high as 6 per cent per month.

The dramatic growth in the Alberta economy was matched by rapid growth at CCB, both on the balance sheet and the income and expense statement. The loan portfolio expanded quickly as lending activities which commenced in July 1976 in Edmonton spread to Vancouver. By October 1977, the bank had launched its Merchant Banking Division. This division in turn promoted the formation of CCIB Mortgage Investment Corporation, a company formed under the *Loan Companies Act*, and regulated by the Department of Insurance of Canada. The CCIB MIC loaned money primarily on residential real estate. It was managed by CCB by contract, although the bank held a minority share interest of slightly over 5 per cent out of a total paid-in capital of $21M.

In 1977, CCB opened branch offices in Calgary and Toronto, and in 1978, in Halifax. In 1979, offices were opened in Saskatoon and in Los Angeles, California (the L.A. Agency). The latter operated under a licence entitling the bank to establish an agency which could not take deposits but was authorized to make loans. Bank spokesmen regarded the CCB's entry into the field of United States domestic loans as a part of a "careful course" for it marked a shift in the bank's international activities away from sovereign risk loans.

In 1980, offices were opened in Montreal and Regina, and by 1981, the bank had established offices in Dallas, Texas and Willowdale, Ontario. In the following year, offices were opened in San Francisco, Denver and St. John's, Newfoundland. Despite the geographic spread of operations, loans authorized by the bank remained heavily concentrated in the provinces of Alberta and British Columbia. But at 53 per cent of the loan portfolio at the end of 1981, the concentration in these two provinces had been significantly reduced from 91 per cent at the end of fiscal 1977.

The CCB continued to launch related ventures. In 1980, again through the Merchant Banking Division, the bank sponsored the Cancom Equity Fund, a limited partnership established under the laws of Alberta, with capitalization of $22.5M. CCB had only 6.7 per cent interest in Cancom, the balance being held mostly by shareholders of the bank. Cancom developed its own management and proceeded with its object of raising and providing to others venture capital. In 1981, the Merchant Banking Division launched a trust under the name of CCB REIT with a capital of $30M. The bank held a 5.6 per cent interest in the trust. As in the case of CCIB MIC, the REIT was managed by CCB under contract.

The capital of the bank was increased, in 1980, in the amount of $25.6M as the result of the exercise of options held by the initial subscribers ($3.6M) and by a rights offering ($22M). After expenses, this brought the bank's subscribed and paid-in capital to $46.3M.

By 1981, several concerns about the economy had clearly emerged: double digit inflation, high interest rates, and uncertainty surrounding federal-provincial agreements on energy. These concerns, and some emerging reservations about Eaton, were assessed by directors in the context of a successful half decade at the bank. Branch locations now numbered eleven, assets had risen from $113M in 1977 to $1.5B in 1981, and the 1981 pre-tax profit of $17.4M was highly satisfactory. CCB shares, issued at $11.00, reached $28.50 in May 1981, and a year later, the bank was pleased by the assessment it received from Canada's two leading rating agencies.

E. CCB MANAGEMENT AND INTERNAL PROCEDURES

1. Internal Credit Procedures and Controls

During the period of early growth, the CCB modified and developed its internal audit system. Initially, as might be expected in a newly formed small banking organization, the bank possessed inadequate internal control systems. There were two main problems: the bank possessed no internal inspection staff of its own, and the bank lacked procedures manuals for staff guidance and training.

The first problem was resolved by retaining the audit firm of Coopers & Lybrand as the bank's internal inspection team. These inspectors reviewed adherence to bank procedures, but did not review or audit any credit decisions. This function was assigned to the head office Credit Department in 1980. Pursuant to a decision taken the previous year, the bank established its own internal inspection department which gradually assumed responsibility for this function.

By fiscal year end 1980, the external auditors, although continuing to be concerned with the bank's inadequate manuals and procedures, expressed the view that internal inspections had improved very considerably, and that credit supervision was good. By the end of fiscal year 1982, the external auditors found that the bank's internal inspection department had progressed to the stage that the auditors were able to rely on the work of that department in conducting the year end audit.

As it ultimately evolved, the internal control system of the bank consisted of two departments, the internal Inspection Department and the head office Credit Department. The functions of the former were to ensure compliance with the bank's established policies and procedures. It was not the Inspection Department's responsibility to assess the reasonableness of the bank's capitalized interest and accruals or to "second guess" the credits made by the branches. Indeed, only two major Schedule A banks have inspection departments which come close to looking at credit judgments.

The head office Credit Department conducted a semi-annual random review of credit underwriting decisions made in the regional credit committees. The head office Credit Department also received a copy of all new loans granted at the regional lending offices. These loans were reviewed to ensure compliance with the policies and standards of the bank.

Senior management in CCB developed in the following way. An Executive Vice-President, Canadian Credit, was charged with responsibility for the granting of credit in Canada. Under this officer, loan applications were approved, special credits were managed and the Canadian loan portfolio in general was monitored. A Special Credits Department was established under a Senior Vice-President whose principal responsibility was the close supervision of the larger unsatisfactory loans. Each region also had a vice-president; these senior regional officers across Canada reported directly to the Senior Vice-President, Canadian Banking. The Executive Vice-President and Chief Operating Officer of the bank was responsible for deposits with the bank, and for the corporate operations of the bank. Other officers included Senior Vice-President Treasury and Money Markets, and Vice-President Corporate Services.

In the United States, CCB had an Executive Vice-President and agent of the U.S. Division of the bank (Robert Heisz). This official reported directly to the President and Chief Executive Officer. Reporting to the Executive Vice-President (U.S.) was the Chairman and Chief Executive Officer of Westlands Bank (Linwood Boynton). This officer had responsibility for approving credit applications in the United States in a fashion similar to the function of the Executive Vice-President of Canadian Credit. The U.S. Credit Department reported to him, along with the U.S. Special Credits Division. The L.A. Agency operational regions (Northern California, Southern California, Rocky Mountain Region) also reported to the Executive Vice-President (U.S.).

The bank had seven lending offices in Canada, three of which were small offices whose credits were all submitted to Head Office for approval. In the four larger offices, there were on-site head office credit representatives who reported to the Canadian Credit Department. Each head office credit representative was a member of a regional credit committee. This officer had a right of veto on any deal. The regional lending limits ranged between $3M and $3.5M. Transactions to any one "connection" or borrower exceeding that amount were forwarded, with the recommendation of the committee, to Head Office. The proposal then received further assessment by head office credit staff, prior to approval at that level. Head office credit staff were also subject to a lending limit. David Smith, the Executive Vice-President, had a lending limit of $10M. Beyond that, loans went to the Loan Committee of the Board. It was the Loan Committee's function to review applications for loans of $10M and over, and to make recommendations for approval to the Board. The decision to approve such applications was made by the Board.

The ongoing management and monitoring of accounts was carried on at a number of levels. Responsibility for the day-to-day management of the account rested with the lending team. This team would follow the financial trends of the company by way of monthly or quarterly interim financial statements, and security margin positions, receivables and inventory on a monthly basis. This team was responsible for making periodic on-site inspections of the borrower. A credit services department in each lending office carried out the administrative function. This group ensured the receipt of all required ongoing information from each borrower. If a deficiency was noted, an "out-of-order" report would issue, which would bring the problem to the attention of the Regional Vice-President, and onward, for some loans, to Head Office. In addition, there was a "watch list", which included all accounts downgraded on the bank's loan classification system from a 3 risk rating to a 4 risk rating. Where an account fell to a 5 or 6 risk rating, a marginal/unsatisfactory loan report (MARGUN report) was issued for the account. Each account was reviewed by the authority level on at least an annual basis. If the amount of the account exceeded the regional credit committee limit, a head office review would take place.

The marginal/unsatisfactory loan reports provided a basic overview of the account as of each month end. These reports were forwarded to the regional credit committee, who reviewed the report and forwarded a noted copy to the Vice-President, Credit, Head Office. Where no regional credit committee existed, lending platforms forwarded the reports directly to the Vice-President, Credit, Head Office. The information contained in the reports was consolidated in Head Office for presentation to the Board of Directors and other senior management of the bank.

Management meetings for the senior executives of the bank were held weekly. In addition, the President and Chief Executive Officer frequently visited the Canadian senior credit executives to understand developments in various accounts that had been reported on the previous marginal and unsatisfactory loan reports.

2. Directors

Howard Eaton, who had been the President and Chief Executive Officer of the bank since its earliest days in 1976, became Chairman of the Board in 1981. Gerald McLaughlan, President and CEO at the time of liquidation, joined the bank in 1976 and progressed through senior offices to the level of Executive Vice-President and Chief Operating Officer in 1981, and President in 1982, which office he held at the time Howard Eaton left the bank in 1983. Paul Britton Paine joined the Board in September 1983, and was elected Chairman in November 1983. He continued to hold that position until 1 September 1985.

Throughout most of its history, the CCB Board of Directors consisted of approximately twenty members. The directors represented every region of Canada, California, Great Britain, and France, and over the years included directors of varied and distinguished business and professional expertise such as the former Inspector General, a former Attorney General of British Columbia, a former premier of Manitoba, a former assistant minister in charge of Alberta utilities and telephone, senior officers of a major life insurance company, a former CEO and Chairman of a major financial institution, senior merchant bankers from the United States and Europe, directors or officers of large pension funds and credit unions, the owners of significant private companies, and the controlling shareholders of public companies.

As it evolved, the Board of Directors of the CCB had two distinguishing features. First, the majority of the directors represented directly the major shareholders of the bank of which there were about 12 by 1985. Those shareholders holding 3 per cent or more of the issued capital stock at 1 November, 1984 were:

Air Canada Pension Trust Fund
Alberta Government Telephone Employees' Pension Fund
M. Belkin
Alberta Teachers' Retirement Fund
Caisse de Dépôt et Placement du Québec
CNR Pension Trust Fund
The Great West Life Assurance Co.
North West Trust Company
Paribas International
Teachers Retirement Allowance Fund Board (Manitoba)
S.G. Warburg and Co. Ltd.

Second, following the resignation of Howard Eaton in January 1983, the Chairman of the Board was not the Chief Executive Officer. This was thought to add to the objectivity of the Board of Directors.

The directors played a role in the review and approval of loans made by the bank. The Loan Committee had the following major responsibilities: to approve loans outside management's limits on behalf of the Board; to review and recommend bank lending policies; to review the bank's loan mix (by industry and region); to review out-of-order reports (accounts not in compliance with approved terms and conditions); to review details of loans in arrears, nonearning or partially-earning loans, reservations for losses, and actual loan losses; to review annually the credit system of the bank; and to ensure that where decision-making was delegated, appropriate controls existed and were policed. All director or director-related loans had to be approved by the Board of Directors. Any loan exceeding $10M, which was the management lending limit, had to receive the approval of the Loan Committee of the Board. All loans of $5M and over were presented for review to the Board by way of a Board Sheet, which summarized the details of the loan.

Prior to each meeting the Loan Committee received marginal and unsatisfactory loan reports, nonearning loan reports and a three-month forecast of anticipated NELs, a list of partially-earning loans, a list of uncollected interest on those loans, a report on the mix of loans in the loan portfolio, a report of all new loans approved during the preceding month, periodic reports on particular large accounts in difficulty, and reports on any particular program that management was considering to develop in terms of workout strategy or a new area to pursue.

The Board of Directors itself did not receive the same extensive materials but only an abbreviated summation of the foregoing information. The Chief Executive Officer of the bank received the same materials which the Loan Committee received, and in addition, the summary of the marginal and unsatisfactory loan reports.

On 26 May 1977, the Audit Committee of the Board of Directors was established and its terms of reference approved. The duties and responsibilities of CCB's Audit Committee were as follows:

(a) Review in detail the bank's financial statements and control structures and procedures and report the results to the Board.

(b) Review with management the results of the Inspector General's periodic visits to the bank. Meet, at least semi-annually, with the outside auditors to review matters concerning this aspect of bank control.

(c) Ensure that the bank's internal inspection program is effective.

(d) Meet with the CEO regarding all findings.

The purpose of the Committee was to ensure that the bank's accounting and financial control policies, codes of conduct, financial reports and practices were in accordance with the *Bank Act*, were within acceptable limits prescribed by regulation, and were in compliance with applicable accounting and taxation requirements. In order to perform its duties, the CCB Audit Committee met regularly with, and reviewed quarterly reports on inspections from, the Chief Inspector who compared any changes in ratings and discussed trends. Unsatisfactory reports were followed up with management. Audit Committee members met at least twice a year with the outside auditors who were given notice of all meetings and provided with copies of all Audit Committee minutes. The Committee reviewed supplementary materials from management concerning the financial statements and reviewed with management the results of OIGB visits to the bank.

F. EMERGENCE OF CANADIAN DIFFICULTIES AT CCB

1982 was the first difficult year for CCB. Profits had been uninterrupted and rising since its first year, but now the Western Canadian economy, where CCB's portfolio was concentrated (Table C.2), was collapsing. The trouble started when oil development expenditures and exploration activity began to fall off in Alberta. Land values experienced a dramatic decline. Unemployment rose, and emigration from the province accelerated markedly. The Alberta market for goods and services collapsed. Many Alberta middle market companies, unable to weather the storm, collapsed with it. Heavy debt had become a way of life for Alberta and British Columbia business. A rising economy in both volume and price had easily sustained debt levels in the past. The recession, initially expected to last for six to eight months, lasted thirty months; many enterprises were crushed under the weight of debt and overhead. The customers of CCB were not immune. In all probability, given their predominant concentration in oil and gas and real estate, CCB's borrowers were hit harder than a cross-section of businesses in the Alberta economy.

The impact of the decline of the Alberta and British Columbia economies on banking was not confined to the CCB. Representatives of major Canadian banks active in Western Canada testified that they too suffered significant losses in the region during the early 1980s. Other witnesses confirmed that the economic decline had damaging consequences throughout the financial system. Most of CCB's loan losses and nonearning loans were in British Columbia and Alberta as Tables C.3 and C.4 illustrate.

Moreover, there was excessive concentration in real estate and energy. The problem of concentration had been recognized before 1980, and on 1 February 1981, new loan guidelines were established which restricted real estate-related loans to 40 per cent of the total portfolio, and energy loans to 25 per cent. New lending limits were imposed upon project lending in real estate. In May 1982, when the guidelines were revised, the real estate mix was reduced to 37 per cent. Term loans relating to real estate were reduced from 35 per cent to 28 per cent of the total portfolio. Construction and project loans were mostly restricted. Real estate and energy concentrations were reduced, as were British Columbia and Alberta loan authorizations. These reductions were made while the bank was under the command of Eaton. Effective 27 April 1982, Eaton announced that the bank was to operate under a management philosophy of "emergency conditions". Eaton advised the Board that "These conditions are imposed by a dramatic alteration in Canada's economy, serious change in Canadian banking, and by underplan performances in almost all facets of CCB's financial results."

Management appeared somewhat puzzled, at this time, by the rapid downturn in CCB performance. McLaughlan wrote to Eaton in July 1982 to outline his views about why CCB's nonperforming loans

Table C.2

Canadian Commercial Bank
Geographic Distribution of Outstanding Loans

	1980[a]	*1981*[a]	*1982*[a]	*1983*[a]	*1984*[a]	*1985*[b]
			(per cent)			
Lending in Canada						
British Columbia	14.8	16.2	15.5	14.1	13.7	13.2
Alberta	51.0	41.8	37.7	36.5	31.0	30.9
Saskatchewan/Manitoba	2.9	5.4	4.7	4.4	1.5	1.3
Ontario	12.2	13.1	12.5	11.3	10.3	12.7
Quebec	0.9	4.1	3.8	3.8	3.3	3.0
Atlantic Provinces	3.4	1.6	1.7	2.2	2.3	2.6
Total Canada	85.2	82.2	75.9	72.3	62.1	63.7
Lending Outside Canada						
United States	10.1	15.4	22.9	26.7	37.2	35.6
Other international	4.7	2.4	1.2	1.0	0.7	0.7
Total Foreign	14.8	17.8	24.1	27.7	37.9	36.3
	100.0	100.0	100.0	100.0	100.0	100.0

[a] As at 30 September.

[b] As at 30 June.

Table C.3

Geographic Distribution of Loan Loss Experience

	1977	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*
				($ 000s)				
Canada								
British Columbia	250	72	977	600	(1,129)	2,222	1,412	5,303
Alberta	—	314	23	127	170	1,314	8,621	10,213
Saskatchewan/Manitoba	—	—	—	—	—	630	120	—
Ontario	—	—	200	800	753	1,173	2,029	1,995
Quebec	—	—	—	—	800	2,444	55	401
Atlantic Provinces	—	—	—	650	710	(187)	(90)	125
Total Canada	250	386	1,200	2,177	1,304	7,596	12,147	18,037
United States								
California	—	—	—	—	600	1,090	1,731	2,003
Texas	—	—	—	—	—	—	—	—
Colorado	—	—	—	—	—	2,176	629	5,143
Total United States	—	—	—	—	600	3,266	2,360	7,146
International	—	—	—	—	—	—	—	—
Total Bank	250	386	1,200	2,177	1,904	10,862	14,507	25,183

Table C.4

Canadian Commercial Bank
Geographic Distribution of Nonearning Loans[a]

	1981[b]	%	*1982*[b]	%	*1983*[b]	%	*1984*[b]	%	*1985*[c]	%	*1985*[d]	%
British Columbia	1.3	10.3	14.2	18.1	14.5	12.1	27.5	14.1	25.4	10.5	42.6	11.9
Alberta	2.5	19.9	37.8	48.1	40.7	34.1	71.6	36.9	98.5	40.9	143.4	40.1
Other Canadian Provinces	4.5	35.7	5.3	6.7	27.3	22.8	8.5	4.4	15.8	6.6	32.8	9.2
Total Canada	8.3	65.9	57.3	72.9	82.5	69.0	107.6	55.4	139.7	58.0	218.8	61.2
Total United States	4.3	34.1	21.3	27.1	37.0	31.0	86.6	44.6	101.2	42.0	139.0	38.8
Total	12.6	100.0	78.6	100.0	119.5	100.0	194.2	100.0	240.9	100.0	357.8	100.0
As a percentage of eligible assets		0.89		4.19		5.91		7.93		9.55		13.64

[a] Nonearning loans are net of specific provision for losses.

[b] As at 31 October.

[c] As at 31 January.

[d] As at 1 May, post-assistance.

had reached "devastating proportions". McLaughlan's conclusions were:

1. Senior management's failure to monitor the external environment systematically. Consumers were found to be saving rather than spending. Management failed to recognize fundamental changes made by the recession and deflation. Above all, management underestimated competitive disadvantages of Canadian high technology industries and ignored the devastating impact of the NEP and the November budget of 1981.

2. Loan size concentrations. CCB had an inordinate concentration of loans in the $10M and over category. Accordingly, while NELs were few in number, they currently represented 10 per cent of total assets.

3. Loan administration. The bank suffered collection problems in a region that did not have high loan administration standards.

4. Conventional collection procedures. The bank had been pursuing the historical approach to solve problem loans; that is, continuing to leave management in the borrower's hands while the borrower's business continues to erode.

5. Credit granting mistakes. CCB had unquestionably made some bad credit decisions. The bank moved aggressively into financing drilling rig contractors, which was probably one of the most cyclical industries in North America. This deficiency was a credit policy error. Credit problems also emanated from certain weak regional vice-presidents.

6. Real estate concentrations. Real estate loans in 1982 represented 67 per cent of the nonearning portfolio.

7. The mid-market high growth clients of CCB were found to be inherently weak in a difficult economic climate.

On 31 January 1982, CCB's marginal and unsatisfactory loans (MULs) represented 4.1 per cent of the bank's portfolio. In the ensuing eight months, MULs quadrupled to 16 per cent. In the British Columbia and Rocky Mountain divisions of the bank, MULs stood at 26 per cent. Specific provisions for loan losses climbed from 0.26 per cent of the portfolio in 1981 to 1.0 per cent in 1982. Profit, which had increased by 77 per cent in 1981, declined by 14 per cent in 1982, and, in terms of pretax profit, by 28 per cent.

Signals that all was not well at CCB entered the regulatory system late in 1982 when Bank of Canada officials learned, during a visit to the CCB in September, that the bank had lost a dozen Canadian and several U.S. deposit accounts, and that a number of loans were in difficulty, including oil industry loans. President McLaughlan expressed concern about a loss of confidence which might culminate in a run on the bank. Then in October, the Bank of Canada received informal reports about the health of the CCB. The Governor and senior Bank of Canada officials were advised that "These comments are never very specific, but tend to infer that the Bank has a large number of real estate and oil industry loans that are in difficulty and that its financial position is worse than is commonly believed". These comments were made in a Bank of Canada internal memo produced to the Inquiry from the files of the OIGB. At the end of 1982, at least one director was also concerned that CCB might have become "overextended" as a result of "adventuresome growth" and that the "rapid growth and expansion may have been partly at the expense of fundamentals". DesBrisay wrote:

> During the past year we have been told of substandard lending practices in our Vancouver platform and of similar problems in Quebec and at least one of our U.S. offices. We have heard of waste and inefficiencies in Bancorp. We know that Cancom Equity Fund has been mismanaged. CCB Leasing, I understand, may have been misconceived.

G. HOWARD EATON, THE TRUST COMPANIES AFFAIR, AND THREATS TO CONFIDENCE IN THE CCB

Starting in 1980, several concerns about Eaton gradually emerged and were expressed by the Board of Directors. One was an apparent growing isolation from the Board. Another was Eaton's personal move to the United States. One bank director, DesBrisay, heard rumours in 1979 that the long-term plan for the bank involved Eaton's moving personally to California to oversee a substantial bank presence in that state. In the summer of 1980, Eaton caused the bank to purchase a residence in the vicinity of Los Angeles in order that he could split his executive time between Canada and the United States. This residence was subsequently sold, and Eaton purchased a second with financial assistance from CCB which received an assignment of legal title to this property by way of a deed of trust. To the directors, the CEO's isolation from the Board and the bank's California expansion appeared to be linked. The directors called Eaton to account for these moves but, in mid-1981, did not consider that radical action was appropriate in light of the bank's growing presence in the United States and the successful performance of Canadian operations. A third concern arose when Eaton began to make personal business investments in the financial sector. These would occupy his time and had the potential of placing him in conflict with the bank.

In August 1982, Eaton advised the Board that he and Leonard Rosenberg, a Toronto financier, and others were forming an organization that had a very elaborate concept and plan. It was almost a bank. Eaton proposed that this organization buy from CCB its United States operation and that in turn CCB would invest in the new organization. The organization would have a number of other major business interests, including an oil company, and was contemplated to have capital of approximately $100M. Most of the Board members were indignant about this proposal. It indicated to them that Eaton was no longer interested in the bank but was going forward with a major business development proposal of his own.

Rosenberg's association with Eaton apparently commenced in 1982. In that year Greymac Mortgage held a 10 per cent share interest in CCB. Rosenberg represented this interest on the Board of the bank after April 1982. In accordance with policies established by the OIGB, he resigned as an officer of Greymac Trust on joining the CCB Board. By October 1982, Greymac Trust, Crown Trust, and other companies associated with Rosenberg had acquired about 30 per cent of the shares of CCB. In October of 1982, Rosenberg resigned from the Board of CCB. CCB refused to transfer the shares acquired by this group of companies as they exceeded the 10 per cent ceiling provided by the *Bank Act*.

These developments also concerned the Inspector General. He felt that Eaton's investment activities were contrary to the proper conduct of a Chief Executive Officer of a bank. In the Inspector General's words, Eaton was "getting greedy" and "losing sight of bankers' principles". He was also concerned that Eaton was not devoting his full efforts to the bank, and had become partially resident in California. All of the directors received a letter of 5 November 1982 from the Inspector General in which he outlined his concerns regarding Eaton. In response to pressure from the Inspector General, the directors followed up their own earlier concerns and took steps to replace Eaton as Chief Executive Officer of the bank.

At the 30 November 1982 Board meeting, it was decided that the directors should seek advice from the shareholders whom they represented, and the matter was put over to the January 1983 board meeting. Consideration of the problem was interrupted by the "seizure" by the Government of Ontario on 7 January 1983 of Crown, Seaway and Greymac. This produced an immediate effect upon CCB. While the bank was not particularly heavily involved with Rosenberg, and Eaton was in the stages of early association with Rosenberg, there were rumours that CCB had financed Rosenberg's acquisition of the trust companies. This was untrue. It was agreed that Eaton would resign from the Board, and that McLaughlan, who had been the President and Chief Operating Officer, would succeed him as Chief Executive Officer. All of these developments were announced on 25 January 1983.

The Trust Companies Affair accelerated the resolution of the Eaton problem, although this appears to have been untimely from the bank's perspective. In a meeting with the OIGB on 18 November 1982, Eaton stated that he saw no immediate successor should he resign. While both Eaton and Bill McDonald, a director who eventually succeeded Eaton as Chairman, felt that Eaton's immediate resignation would not be in the best interests of the bank, his resignation was brought about in January 1983, and McLaughlan was appointed CEO. He was, at the time, 37 years of age but had 15 years experience in banking, mostly at lower levels of responsibility. After joining CCB in 1976, McLaughlan had advanced from Vice-President, Alberta and Saskatchewan to Executive Vice-President, Canadian Division.

The immediate effect of the seizure of the trust companies, and Eaton's resignation from the bank, was money market turbulence. Concerns were expressed to the Governor of the Bank of Canada by CCB and the Inspector General about declining market confidence in the CCB and the possibility of "contagion" effects on the Canadian financial system. On the evening of 25 January 1983, the Governor consulted the Inspector General and the banking community directly concerning the problems facing the CCB and concerning the possibility that turmoil in the financial markets could escalate rapidly as a result. In view of its perceived responsibility to preserve confidence in the financial system, the Bank of Canada contacted the press that evening. A press release was issued by the Bank of Canada on the morning of 26 January 1983, indicating that the Canadian Commercial Bank was solvent, and that the Bank of Canada would provide liquidity support, if reqired. The Bank of Canada dispatched its Comptroller to the CCB offices in Edmonton to ensure that the Bank of Canada was in a position to provide liquidity advances, if needed, and to monitor the bank's day-to-day funding activity. On 28 January, an agreement was executed whereby the Bank of Canada took security for any advances made to the CCB.

In view of the potential impact of CCB's liquidity difficulties on the financial system, certain chartered banks explored alternative methods of providing liquidity support at the request of the CCB. After receiving positive responses from the large chartered banks regarding the possibility of establishing a special liquidity support package for the CCB, the Bank of Canada convened a meeting of representatives from the Royal Bank of Canada, the Toronto-Dominion Bank, the Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, and the Bank of Montreal ("the five chartered banks") on 7 February 1983. At that meeting, the Inspector General reiterated his conviction that the Canadian Commercial Bank was solvent. The five chartered banks agreed to provide a special liquidity facility to the CCB. During the meeting, the five chartered banks sought a formal undertaking from the Bank of Canada in support of the special facility. The Bank of Canada took the position that its public commitment as lender of last resort should provide sufficient assurance to the five chartered banks and, furthermore, that they should not be provided with more assurance than that afforded to any other depositor in the CCB.

The CCB did not, in fact, borrow from the Bank of Canada under the terms of the 1983 security agreement, but did make use of the special credit facility provided by the five chartered banks. All amounts borrowed by the Canadian Commercial Bank pursuant to that facility were repaid by 22 June 1983, and the facility was allowed to lapse. On 17 October 1983, pursuant to a request from the CCB, the security agreement in favour of the Bank of Canada was terminated.

The bank had, just before the Rosenberg/Eaton publicity, brought a preferred share issue in the amount of $25M to the preliminary prospectus stage. This initiative was abandoned as a result of the Trust Companies Affair. The shares which the trust companies had acquired, amounting to nearly 30 per cent of the CCB stock, were overhanging the market so that raising new capital presented an immense problem. Overall, confidence in the CCB had been eroded. Senior officers of the bank visited large depositors in an attempt to convince them to continue their business with the bank. Larger wholesale depositors, such as the Government of Ontario and Ontario Hydro, were lost and never returned. In March 1983, McLaughlan reported that the episode cost CCB between 15 and 25 basis points (100 basis points being 1 per cent) on the interest costs of its deposits, which added cost was never fully eliminated. There was a perception widely held, without any factual base so far as the evidence in this Inquiry is concerned, that the bank was part of the trust company scandal. This taint never left it.

H. CONTINUING TROUBLES IN CCB'S CANADIAN OPERATIONS

CCB had committed itself to an expansion program in 1980-81 in an effort to reduce the regional concentration. Yet because of the recession, the bank found limited opportunity for new business in the regions into which it had expanded. Moreover, the funding problems caused by the trust company affair necessitated a curtailment of new business. The expansion expenses resulted in a very heavy operating cost burden. During 1983, programs were implemented to reduce expenses. Staff reductions were made. A salary freeze was put in place. In January 1983, zero-base budgeting was introduced and less profitable offices were closed. Noninterest expenses, as a ratio to average assets, climbed in 1983 reflecting the expansion program, but declined in 1984.

It was also recognized that the concept of wholesale funding on which the CCB had been founded was no longer acceptable. The bank established reserves sufficient to carry it for ten days without accessing the money market. In addition, commencing in April 1983, CCB attempted to build a retail deposit base. Retail deposits were increased to 4 per cent of total deposits by the end of 1983, and 25 per cent of total deposits by 1985. In 1983, the bank had 2000 depositors, and this was increased to 15,000 depositors in 1985. This program of course increased the bank's expenses.

In March 1983, the CCB updated the OIGB on its financial condition. CCB was then paying a premium of 15 to 25 basis points for its deposits, by virtue of the Rosenberg affair. Development of new business had been terminated in order to relieve funding pressures, and the substantial growth in noninterest expenses was expected to impact very negatively on the profitability of the bank when coupled with narrowing interest spreads. CCB continued to experience problems with its Western Canadian loan concentration. The NELs could not be reduced instantly because CCB clients, middle market businesses, did not have ready access to equity financing, and their only capital source (profitability) was eroding due to the recession. By this time, the market was so depressed in Alberta that assets held by the bank as security could not be disposed of for acceptable prices. Even at drastic price levels, buyers were hard to find. The DBRS, a rating service, reconfirmed CCB's paper at R-1 (low).

On 30 June 1983, McLaughlan took further steps to tighten the lending policy by placing a lending limit of $10M on any one loan, and restricting the types of real estate loans that could be made. Real estate loans were 40 per cent of all loans at this time. They were not being reduced, however, because existing real estate loans were not being retired. In further response to the crisis, McLaughlan strengthened the Special Credits Group to provide intensive care to troubled loans. The types of workouts pursued by this group included the transfer of troubled real estate loans to special purpose companies with little or no capital, and with funding advanced by the bank for the purchase of the security held by the bank. The bank would also take a profit-sharing position in the purchaser. Bad loans continued to increase throughout 1983. MULs, which had stood at 16 per cent of the portfolio as of 30 September 1982, had increased to 17.88 per cent as of 25 January 1983. However, the increase in MULs in the U.S. portfolio for the same period was 60 per cent. Further, the loans judged by CCB to be "more than average risk" stood at 31.45 per cent as of 25 January 1983, even though MULs stood at only 17.88 per cent.

Table C.5

CCB Financial Indicators 1983-84

Financial Indicators (OOO's)	*1984*	*1983*
Loans	2,415,927	2,006,231
Appropriations for contingencies	16,596	23,947
Contributed surplus	25,680	25,334
Retained earnings	112	7,372
Interest income	284,128	221,587
Total interest expense	256,883	191,419
Net income for the year	804	6,505
Loss experience on loans	25,000	14,500
Provision for loan losses	14,800	9,000

It can be seen from the financial indicators set out in Table C.5 that the appropriations for contingencies account declined in 1984 by 30 per cent. The function of this account is to act as a reserve for unforeseen future loan losses. An unsophisticated reader of bank financial statements might conclude from the decline in the account that the affairs of the bank were improving while, in fact, the opposite was true. The account is depleted by rising loan losses which are recorded in the financial statements. It is replenished by transfer from retained earnings or surplus. Acting with the encouragement of the auditors, CCB applied to the OIGB to increase the account for fiscal year 1984 by transfer from contributed surplus. The OIGB denied this transfer on the ground that the entire capital of the bank is a buffer for loan losses. As well, it was impossible to make the transfer from retained earnings because it is not in compliance with generally accepted accounting principles to force the retained earnings account into a deficit. The account can only be forced into a deficit from operating losses. In the 1984 financial statements, this account did not present the true picture of losses, actual or apprehended.

The notes to the CCB financial statements are mostly unexceptional. Loans were stated to be carried at their principal amount less any specific provisions for anticipated losses. The accrual of loan interest income was discontinued where interest or principal is contractually past due 90 days unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal and interest. Practices underlying the determination of the principal value of the loan (such as capitalization of interest), and of the establishment of a provision (such as the use of baseline values for security valuation) are not required to be disclosed in the financial statements of a bank, nor are such matters customarily disclosed in the statements of the major banks. These practices and their significance are discussed fully in the Analysis section of this Report.

Table C.6

CCB Income Trend 1981-84

Year	*Net Income*	*Percentage Change in Net Income*	*Pretax Income*	*Percentage Change in Pretax Income*
1981	9.9M	76.8%	17.4M	68.9%
1982	8.5M	(14.1%)	12.6M	(27.6%)
1983	6.5M	(23.7%)	8.2M	(34.9%)
1984	0.8M	(87.6%)	(6.9M)	(184.1%)

A trend of declining net income from 1982 to 1984 is revealed in Table C.6. In 1981, the bank's net income of $9.9M had been a 76.8 per cent increase over 1980. By 1984, the bank had suffered its first loss (before recovery of income taxes).

The deterioration of assets in CCB (Canadian and U.S. Division combined) after 1981 was very dramatic, as illustrated by Table C.7.

Table C.7

CCB Asset Quality 1981-85

Type of Loan	*1981*	*1982*	*1983*	*1984*	*31 Jan. 1985*	*30 Apr. 1985*	*31 July 1985*
MULs	42M	298M	466M	574M	744M	691M	723M
MULs as a % of total loans	3.4	17.8	20.2	25.4	29.2	29.0	29.0
Non earning loans	13M	79M	120M	194M	255M	409M	434M
NELs as a % of total loans	0.9	4.2	5.9	7.9	10.1	17.2	18.9
Loan loss experience (millions)	1.9	10.9	14.5	25.2			
As a % of eligible assets	0.13	0.58	0.72	1.03			
% increase over year		465.2	33	74			

I. CALIFORNIA OPERATIONS AND U.S. REGULATION

1. Westlands

Following a consultant's favourable study and examination, CCB acquired an interest in Westlands, a California bank, in September 1981. The acquisition of a 39 per cent interest was consistent with CCB's original intention to operate outside Canada's borders. California was considered to be a suitable region for expansion because of certain similarities with the Canadian banking environment, notably a perceived gap in banking services in the middle market. (Details of the Westlands capital structure and holding company arrangements are omitted as unnecessary to an understanding of the Westlands investment.)

Westlands was acquired because the CCB's L.A. Agency had no deposit-taking authority; hence, acquisition of a U.S. domestic bank was necessary to pursue a fully integrated expansion into this market. Westlands was recommended for acquisition by a consultant's study commissioned by Eaton. It was presented to the Board in November 1980. After vigorous debate, it was agreed in principle to acquire 39 per cent of the bank along with sufficient warrants to take CCB to a controlling position. Consolidation with CCB's operations was not desired at the outset for, while Westlands had some attractive features including its ability to generate deposits and its computer software services provided to title and escrow agents, the bank had suffered in the California real estate recession, and had indeed suffered losses from 1974 to 1976. Consolidation of accounts was therefore undesirable and so a majority position was not taken. Even by 1980, capital was impaired, growth was restricted by the capital problems, profitability was low, a number of long term low yield mortgages remained on the books, and the deposit base, consisting mostly of demand deposits from the escrow industry, was unstable. Some directors expressed their view that Westlands had problems, that it had not yet demonstrated a return to profitability, and that CCB was overpaying to buy into a turnaround situation. The majority of directors, however, considered that Westlands had good prospects for a return to profitability, and indeed, forecasts prepared by the consultant showed rising profitability for all the forecast years, 1980 through 1984. In the result, the purchase of this bank, with a loan portfolio highly concentrated in real estate and funded on the volatile wholesale deposit market, was approved. This improvement was to proceed under control of Westlands' existing "good professional management", with the close monitoring of CCB's Executive Vice-President, United States. Upon return to profitability, Westlands would become CCB's U.S. banking vehicle, and the Agency would be wound down.

By 1983, the truth about Westlands had been revealed. Management were incompetent, the portfolio had not been diversified, and deposits had become even more concentrated in the brokered deposit market. DesBrisay testified that these matters had not been obvious in 1981.

> The mistake was, after acquiring Westlands, we did not go into it, as we later found out, and put in our systems and see that there was a first-class management team. We put somebody in charge of the whole United States banking operations that was not a banker. That was certainly one of the dumb things, in retrospect, that we did.

McLaughlan stated that Westlands had been treated as a passive investment.

On 17 October 1983, the results of an inspection of Westlands by the Federal Deposit Insurance Corporation of the United States, which was the federal inspection authority for that bank, reached the OIGB in Canada. The FDIC report indicated inadequate supervision by the Board, an excessive volume of adversely classified loans, inadequate capital, poor earnings, inadequate liquidity, highly volatile liabilities, and incompetent management. The report indicated that Westlands was in worse condition than both CCB management and the OIGB had thought. Although some CCB directors or officers were on the Westlands Board, the OIGB did not take this as a criticism of the CCB Board since CCB advised the OIGB that steps were being taken to replace Westlands' management and directors with CCB personnel. The OIGB concluded that the problems arose from the days when Eaton was on the Board of Directors of Westlands. The FDIC inspection of Westlands began in March 1983 when the impact of the Eaton Board would still be felt on Westlands.

McLaughlan joined the Westlands Board in April 1983 and directed a series of measures designed to strengthen operations. He caused CCB Bancorp Inc., the U.S. holding company of the CCB, to withdraw from certain real estate activities in the United States, and removed from the Westlands Board the directors who had been involved in these activities. A new Chief Executive Officer, Linwood Boynton, was appointed at Westlands, and by February 1984, the President, Chairman, Chief Credit Officer, and Controller of Westlands had been replaced with CCB personnel. Much of this was in response to a "cease and desist" order issued against Westlands by the FDIC in October 1983.

On 27 June 1984, CCB purchased the remaining 61 per cent of the outstanding shares of Westlands. CCB took full control of Westlands for a number of reasons. First, the U.S. regulators had exerted pressure on CCB to save Westlands because CCB was a large minority shareholder. Second, CCB had obliquely agreed in 1981 to be a potential source of capital to Westlands. In 1983, the FDIC demanded a $5M capital contribution which CCB was unwilling to give without full control. Third, California was still regarded as an attractive place to diversify. If Westlands and its existing branch network were abandoned, CCB's opportunities to do business in the United States would be destroyed because the L.A. Agency could not take deposits. Fourth, Westlands had a line of computer software products which could be profitably marketed to other financial institutions. The software earned $1M in revenue in 1984; for 1985, the budgeted figure was $4M or $5M (Cdn.). Finally, by 1984, the Westlands loan portfolio seemed purged of problem accounts, management had been improved, and Westlands was not paying tax because of a large loss carry-forward. CCB therefore expected to enjoy a net after-tax profit from the Westlands operation.

Westlands was an expensive acquisition. The 39 per cent interest had been acquired for $5.4M (U.S.) plus a capital note advanced by CCB in the amount of $3M. In July 1983, CCB extended a $10M credit facility to Westlands in lieu of an immediate capital injection demanded by the regulators. The balance of Westlands' shares, 61 per cent, cost $3.6M. Further, between 28 June 1984 and 2 July 1984, CCB acquired loans from the Westlands Bank for $87.3M (U.S.). These loans were problem loans which were taken over by CCB in order that Westlands could make profit and thereby use its tax loss carry-forward. Between June and October 1984, CCB contributed $44.5M in capital to Westlands by a transfer of better quality L.A. Agency loans. CCB also loaned to Westlands, at fiscal year end 1984, a $41M discount debenture. The income earned on this debenture was applied to pay down the $10M credit facility and the capital note with the object, again, to accelerate recovery by Westlands of its tax loss carry-forwards. In short, CCB injected $98.8M (U.S.) into Westlands over and above the $87.3M (U.S.) purchase of problem loans from Westlands.

By February 1984, the only outstanding issue regarding Westlands was the capital contribution to be made to Westlands, the other matters in the cease and desist order having already been resolved. However, the poor performance of Westlands affected CCB's results. On 23 March 1984, McLaughlan reported to the OIGB on CCB's 1984 first quarter results. Earnings declined 37 per cent from the comparable period in 1983. The major factor was the recognition of CCB's 39 per cent share of losses sustained by Westlands following a substantial increase in Westlands' provision for loan losses. The impact of the affiliate's loss was amplified through equity accounting as the CCB was unable to generate any tax relief in the transaction. From September 1981 to 27 June 1984 CCB took into its accounts 39 per cent of the earnings or losses in Westland. Thereafter 100 per cent of Westlands' losses were consolidated into CCB's accounts.

It appears, however, that the directors had for sometime been unaware of the extent of the problems in Westlands Bank. One CCB director, Peter Darling, in a letter of 6 April 1984, described CCB's investment in Westlands as "an appalling legacy from the Howard Eaton days". Darling stated that the directors had consistently underestimated Westlands' capital needs. After the initial acquisition, some indication of how the Westlands' investment was treated in CCB can be seen from the following quotation from this same letter:

> ... Subsequently to our initial investment, Westlands became a taboo subject at CCB board meetings and questions addressed to Eaton were turned aside, but it is clear that further infusions of capital far in excess of our expectations were required. Can we be sure the same will not be true in the future if Westlands is to prosper rather than just survive?

In reply, McLaughlan assured Darling that "we have the requisite talent and market opportunities to rebuild Westlands and restore it to profitability over the next 18 to 24 months".

The magnitude of problems in Westlands Bank was not disclosed or understood until CCB management was installed in Westlands Bank. The absorption of unanticipated losses at Westlands Bank reduced CCB's 1984 earnings by $6.5M. The impact of the acquisition of Westlands on CCB net income for the year ended 31 October 1984, taking into account acquisition costs, share of Westland losses, contributed loans, bad loans assumed, loss of earnings on advances to Westlands, amounted in all to $7.5M. Loss recognition in the CCB accounts for 1983 brings the total impact (subject to some technical adjustments under taxation statutes) to approximately $9M (Cdn.).

Once the course of investment in California was set in 1981, the losses in the later years became as unavoidable as some of them were unforeseeable. Westlands was not without prospects. It had an apparently valuable property in computer software. It was earning a profit in 1981. 1983 was the first year that Westlands had suffered a loss since CCB's initial involvement in 1981. Net income had remained more or less stable from 1979 until 1981, and a rapid decline in net income was experienced in 1982 due to the sagging California real estate market. Perhaps even more serious was the drain on CCB's managerial energies in 1983-85 at a time when the Canadian base of the bank's operations came under siege. In CCB's *Strategic Plan 1985-1987*, a document completed in December 1984, McLaughlan described Westlands as "consuming an inordinate amount of senior management time". Westlands' loan portfolio being concentrated in real estate was hardly a sound diversification measure.

2. L.A. Agency

CCB operated a branch, called an Agency, in Los Angeles, California from 19 November 1979 onwards. The Agency was established with the object of diversifying geographically the bank's loan portfolio. Other branch offices were later established elsewhere in the United States.

The loans outstanding in the L.A. Agency over the past several years are set out in Table C.8.

Table C.8

CCB L.A. Agency Loans
1982-85

Date	*U.S. Dollars (000's)*
31 October 1982	256,900
31 October 1983	370,100
31 October 1984	343,190
31 January 1985	257,900

The condition of Westlands as described in the preceding section precluded its immediate use as the CCB United States marketing vehicle. Hence, in the interim, the L.A. Agency was maintained as a lending base. By February 1984, the FDIC cease and desist order had been satisfied in all respects but for the infusion of additional capital into Westlands. This was resolved, and in June 1984, CCB acquired a 100 per cent interest in this California bank. As a result, it became CCB policy to wind the Agency down.

As has already been seen, bad loans were transferred from Westlands into the Agency, and good loans were transferred from the Agency into Westlands. The effect upon the Agency is, in part, illustrated by the comments of Bruce Cockburn, who was appointed as a Special Representative of the Inspector General pursuant to the CCB support arrangements of March 1985. Out of the 76 support group loans in the L.A. Agency, 46 were real estate loans, accounting for $42M of the $142M of loans from the Agency in the support group. Cockburn testified that approximately 2/3 of those real estate loans originated in Westlands Bank. The Agency also possessed a large number of energy loans, which must now be described.

Prior to the economic collapse of the U.S. oil and gas sector in 1982, CCB had been lending aggressively to the contract drilling industry for the purchase of land drilling rigs. This policy left the U.S. Agency with a number of difficult situations where land drilling rigs served as collateral in an environment in which equipment values were falling as much as 80 per cent and very little profitable work was available to the bank's customers. To assist borrowers and to avoid the alternative of liquidating drilling equipment in a distressed market, CCB (L.A. Agency) initiated a bank-sponsored drilling program (BSDP) in mid-1983. This program entailed CCB funding single-purpose third party oil companies (the "Operator") for some combination of the costs of lease acquisition and drilling "low risk" development-type drilling locations in proven oil and gas fields. The bank took a small equity participation in the resultant oil and gas wells as well as the normal cash flow dedication required to repay the drilling loan. As a condition of the loan, the Operator was required to use a drilling-rig operator designated by CCB (the "Driller"). CCB would then finance the acquisition of rigs either from troubled borrowers of the CCB or from CCB itself. The acquisition price was in most cases the face value of the existing CCB loan. CCB would then fund the Operator, who in turn would pay the Driller, who in turn would pay the interest on the acquisition loan to CCB, which CCB would show as income. The economics of the project were based on stable oil prices at between $28 to $30 per barrel. The availability of far cheaper rigs threatened the project's economics from the outset.

In a memo dated 5 April 1983, Boynton, the then Vice-President, Special Credits, stated with respect to the BSDP, that:

> You will appreciate that the program described above is not without considerable risk to the bank and goes beyond ordinary lending criteria. The willingness of the bank to undertake such risk is a reflection of the concern over the non-earning rig loans and the conclusion that the risks are worth taking, subject to scrupulous engineering, *to avoid substantial and unpalatable write-offs*. (emphasis added)

McLaughlan acknowledged that the drilling industry was volatile and that the bank had excessive exposure to it. However, he testified that, because the rigs were involved in development drilling rather than exploration, he did not agree that the BSDP was a high risk loan recovery strategy and that the CCB risked "any additional money".

On 5 December 1983, Neville Grant of the OIGB visited U.S. banking regulators associated with the Federal Reserve Bank of San Francisco, FDIC, and California State inspectors. These officials had completed an examination of CCB's U.S. Agency in late 1983. Grant was told that there were concerns with the quality of the loan portfolio in the L.A. Agency in energy and real estate. California banks were then writing down loans in the drilling rig sector, and CCB should be doing the same. Grant testified that he was advised by "CCB's Canadian auditor" that the auditor was satisfied that there had been no significant deterioration in the loan portfolio of the L.A. Agency. Grant did not identify his informant.

McLaughlan attended the exit interview of the California State Examiners in late 1983. He testified that the examiners agreed with CCB loan classifications; NELs had been written down, and loans in the rig program were satisfactory to the examiners. The examiners subsequently changed their position, and advised the OIGB on 12 December 1983 to expect a bad report on the Agency. Between the exit interview and the report, a state examiner had decided that there was an inadequate track record regarding the rig program. Accordingly, writedowns were necessary. Doyle told the CCB, as he would have advised any foreign bank in a similar dispute, to write the loans down or "take them home". Starting in March 1984, CCB elected the latter course; marginal loans and loans criticized by U.S. regulators were transferred to head office in Canada. McLaughlan admitted he was fed up with the regulatory system in the United States, but stated that he decided to transfer these loans to the head office in order to wind down the Agency in accordance with plans to utilize Westlands as the sole CCB market vehicle in the United States. He denied that the transfer was made to avoid tougher regulation over the quality of CCB loans. In any event, the Inspector General was supportive of CCB's workout programs and critical of the more general U.S. approach of writing down loans by sector.

CCB recognized certain weaknesses in the BSDP. Due to the rig surplus, one could purchase a rig for less than the amount for which CCB could transfer repossessed rigs to other customers. Therefore, competition could drill more cheaply than a CCB client, and any drop in the price of oil from the $28 to $30 (U.S.) range would have an amplified impact on CCB's client drilling contractors. In a falling market, CCB's client drilling contractors would be unable to compete. Yet there were several offsetting factors: (a) CCB drillers were experienced; (b) not all surplus rigs were located in California where loans were booked (CCB drillers had their rigs on location, which was an advantage); and (c) production funding was drying up. Since the CCB was prepared to fund production, leaseholders and their assignee operators were attracted. Thus, prior to February 1985, the BSDP was generally considered to have merit. Indeed, an experienced outside observer later gave the opinion that in late 1983, and through 1984, the program was working and appeared to have merit. On 1 February 1985, Robert Heisz assumed control of the Special Credits Department of the L.A. Agency. Credit officers in the Agency had found evidence of a decline in drilling activity. Heisz therefore caused an examination to be made of the energy portfolio which resulted in serious alarm. The contents of Heisz' report on the U.S. energy loans, the communication of his findings within the CCB, and the extent to which officials of the bank had reason to anticipate or were actually aware of existing difficulties in the U.S. portfolio are important in relation to the CCB's search for assistance in March 1985. Accordingly, fuller consideration of these factors is undertaken in Appendix D.

J. BANKING PRACTICES AND OIGB SUPERVISION

1. Workouts

The recession forced the bank, in 1982, to commence various types of complex workout arrangements. New companies were established and financed to take over real estate securities, manage them expertly, and thereby enhance recovery. In the United States, the bank initiated the BSDP. In some cases a profitable oil and gas security would be married to a problem real estate loan by merging the two borrowers to carry both through the recession. In one case, money was loaned to purchase a strip coupon bond, which on maturity would be of sufficient value to secure the loan workout and the money loaned to purchase the bond.

Shortly after becoming President and Chief Executive Officer, McLaughlan called a meeting, on 26 January 1983, to investigate means of reducing the percentage of nonearning assets on the bank's balance sheet. The senior officers of the bank agreed that, while usual collection procedures that would see the bank recoup its funds should be pursued, difficulties would arise as a result of the depressed values of security held in support of loans. It was further agreed that "some stretch-out of existing arrangements on a basis that would see interest serviced in a regular manner would afford the possible benefit of economic turnaround and workout as well as removing the concentration of difficulties and spreading them over a longer earning period". As a result of this meeting the special credits group was formed and substantial resources were committed to this loan recovery unit. McLaughlan made it clear that this group would develop procedures which went beyond the usual collection procedures:

> The President and Chief Executive Officer made it clear that innovation should be exercised to see clean-up or extension of these troublesome assets effected.

The following extracts from McLaughlan's testimony set out the problems facing management and the approach adopted:

> Q. What could have been done and by whom and when to save CCB?
>
> A. The reasons that I have mentioned earlier, I am not sure, short of a merger, that CCB could have been saved.
>
> Q: How far back was that condition irreversible? Where did it start?
>
> A. It really started in 1983.

. . .

Q. And from that time on, merger was the only sure-fire solution?

A. Well, it was not obvious until much later.

. . .

Q. It was not apparent in 1983. When did you first realize the only way out of the quagmire was a merger?

A. February 27, 1985.

Q. Why was the condition cloaked so deeply that it went two years before a banker of your experience realized it?

A. Because I had certainly concluded, in terms of the U.S. energy loans, that the programs that had been in place were going to deliver the planned results. In terms of the balance of the problems in the bank's portfolio being primarily Western Canada, the recovery that was underway would have seen the bank slowly recover to respectable and stable profits. Until the U.S. energy loans collapsed, I certainly felt we had a reasonable chance of making it, a very good chance of making it.

. . .

Q. Then, what is wrong with management in trying to skate across the thin ice about from early 1983 to September 1985 in adopting accounting procedures which would enhance assets and sustain revenues and still not violate any of the CICA code; what is wrong with that?

A. I see nothing wrong with that.

Q. Is that not the reason that your management, before you took over and during your regime, adopted baseline average and capitalization of interest, workouts, rollovers, Newcos and all these things within the rules of accounting; is that not really the reason that you had to do that?

A. Well, really, the reason, in my impression, was to get through a difficult trough that the bank was in, and not going into a liquidation scenario in that period.

Q. Right, and that was the mode adopted?

A. That was the mode adopted. Using a going concern approach and loan recovery strategies in those two industries – real estate in the west and U.S. energy. Again, these ifs, I guess, are pretty difficult to grasp, but I think this bank, as I said earlier, would have made it without, again, the volatility of that U.S. energy industry.

Robert Lord of Clarkson, Gordon, one of the auditors of CCB, described the generic term workout as follows:

> In the case of problem loans, the bank would be faced with a choice of either collecting the loans, forcing the collection of the loans on an immediate basis, or restructuring them to achieve a better collectability in the future.
>
> The choice really involves the bank as a business decision in deciding whether it should liquidate a loan and dispose of the security in a very depressed market in the case of a number of these loans, taking the large loss that that would involve or, on the other hand, whether they should carry the loan until it could be fully or more fully collected. ...

> ... In the simplest form, carrying a loan at a reduced interest rate or at no interest to provide time to allow the security value of the loan to recover would be one example of a workout ...
>
> ... You might also rearrange the terms of the loan to enable the borrower to repay it over a longer period of time. You might restructure a loan either as to the terms for the payment of interest or the interest rate. You might use an income debenture which, if you could qualify under the Income Tax Act, would allow a business currently suffering losses to pay interest at a substantially reduced rate, which would assist, or you could convert a portion of the loan to equity and retain a portion as debt ...
>
> ... The bank might provide additional financing to the borrower to enable the purchase of assets which would provide cash flow to service the debt. This may involve the use of a tax loss in the borrower to shelter the new income and to enable it to service both the old and the new debt.
>
> An example of this kind of workout would be the use of a new loan to allow a company to acquire, for example, oil and gas properties which would have cash flow or to use, in a more complicated workout, a new loan to allow the use of a stripped bond which, over a long period of time, would provide funds to repay both the debt and the return on the debt. In addition to the financing, another method would be to arrange to bring in new management for the business to improve the operation of the business so it becomes viable and able to pay the loan and service the loan.

The security underlying such workouts was valued on a going concern basis, with expected realization in two to three years. The value thereby determined was referred to in the bank as "baseline value". Such a valuation was meant to meet the problem that security posted with the bank in good times was from 1982 onwards very much undervalued due to the depressed market. This practice (as opposed to a normal going concern valuation) commenced in 1982, and continued on a bank-wide basis in 1983 and 1984. It affected the financial statements of the bank because the value of security is a factor to be accounted for when determining whether to establish a provision for loss in an account, accrue interest, or capitalize interest.

"Company Zero" is a good example of a significant workout. This was an experimental new company which acquired, at the lesser of appraised value and the bank's cost (being principal plus uncollected interest), real estate properties held by the bank after security realization. The bank, in turn, would finance these companies with cost-of-funds loans and effectively retain the same security with the addition of a floating charge debenture. The company was also granted an operating line of credit, secured by a joint and several guarantee of the principals of the company. This line was authorized at $250,000. The sale to Company Zero often included capitalized interest. The loan to Company Zero eventually reached about $23M. The company's principals (one in Canada and one in the United States) were chosen because they had successful records in the real estate business. They invested no equity into the company, and gave no guaranties apart from the guarantee of the operating line. Company Zero was contractually required to pay interest on its loans. However, most of the property transferred had no cash flow and so no interest was paid. Accrued interest was added on to the Company Zero loan but not taken into income of the bank.

There were two concerns with Company Zero. The auditors were concerned that it was the bank's intention to capitalize interest on loans to these companies to the extent of appraised values rather than loan values (capitalization to loan values was the policy of the bank at that time). This concern was brought to the attention of the Audit Committee. The practice of capitalizing to the extent of appraised values was identified as less conservative, and a recommendation that interest only be capitalized up to the loan value was approved. The OIGB was concerned because Company Zero allowed CCB to create a "pool" of assets. Upon a sale, if the price for the asset was below the price for which CCB had sold it to Company Zero, CCB would not recognize the loss nor make a provision on the Company Zero loan. When this actually happened on one property, resulting in a $700,000 loss that CCB did not recognize, the OIGB dispatched a staff member, Courtright, to discuss the matter with Gaudet, a senior bank officer. Courtright's report explains the reasons for the Company Zero deal, CCB's defence of its accounting treatment, and the concrete consequences on the income statement from CCB's "rather liberal and inappropriate" treatment of Company Zero as a "stand-alone vehicle".

> The problem with the [Company Zero] loan is that the valuations have proven to be too great. A sale scheduled to close on April 2, 1983, will see virtually half of the properties sold for $1.1 million. This would leave a loan outstanding of $1.7 million and the most realistic value which could be given to the remaining property is perhaps $1 million. This means that there will be a $700 thousand loss on this transaction.
>
> I enquired with Gaudet whether this would mean that the Bank would write off $700 thousand and was startled to find that it was not planning to do so.
>
> I suggested that in reality the Bank had lost the $700 thousand at the time that it had to foreclose the [1.7 mm] loan and that conservative provisioning would have taken the loss at that point. Gaudet admitted that with hindsight this was true. However the Bank had felt at the time that it could realize the roughly $3 million or more on the properties and had in good faith not taken the provision.
>
> I conceded this point to Gaudet but enquired why now that the facts were known a provision would not be taken at this point. Gaudet indicated that now the loan was part of the [Company Zero] deal and was no longer a tag-end of the [other] deal. He indicated that while [Company Zero] may be down $700 thousand on this property it could make that much or more on the sale of subsequent properties.

> Gaudet indicated that he keeps a careful tab of the estimated realizable values on the [Company Zero] properties and the loan values against them. By loan value he means the cash advance and the amount of interest which had been capitalized. Gaudet indicates that he does this for all of the [Company Zero] properties collectively and that at this time in spite of the loss of $700 thousand on the [1.7 mm] property, there is only a marginal discrepancy between his estimate of the value of all of the properties which [Company Zero] is trying to sell and the Bank's loans to [Company Zero]. He suggested that if this gap was to become significant then provisions would have to be made against it.
>
> I questioned this practice indicating that it appeared to be open ended and that the Bank could presumably defer a provision that it should make by transferring into [Company Zero] a property which it estimated would sell at a good premium over the transfer price.
>
> I suggested that in reality that Bank had underprovisioned on the [$1.7 mm] deal and that it would be appropriate for it to recognize this now that the property was liquidated.
>
> Gaudet indicated that there was nothing that the principals of [Company Zero] would hate more than for the Bank to take such write-downs or losses because the Bank's deal with [Company Zero] regarding profit sharing between the principals and the Bank meant that the loss of some $700 thousand on the [$1.7 mm] properties would have to be more than offset by gains on the sale of subsequent properties before there was a defined profit which could be split between the Bank and the principals.
>
> I indicated to Gaudet that this was immaterial to whether the Bank took a provision or not and that its accounting and its deal with [Company Zero] could proceed as planned and quite independently of the Bank taking any provision on this transaction.
>
> Gaudet did not seem to see things this way and argued that the [Company Zero] company was a unity and the twelve or more properties in it formed a diversified portfolio on which the Bank hoped that gains would more than offset losses. While there was valid reason for this hope to persist, he would not recommend that provisions be taken on the loss on the sale of certain properties.
>
> I raised this concern with Mr. Macpherson who agreed that it certainly appears to be rather liberal and inappropriate to treat [Company Zero] as an arm's length and bona fide and stand-alone vehicle when in fact it was very much a creature of the Bank which had been formed for the expressed purposes of liquidating properties.
>
> A third concern which comes out of the [Company Zero] type dealing is the matter of interest which has been capitalized prior to the properties going into [Company Zero].

Courtright contacted the auditors on 21 April 1983 to discuss Company Zero. While the auditors had recommended to the bank, at 1982 fiscal year end, that interest not be capitalized beyond the normal lending value of the underlying security, the bank had apparently disregarded this advice. Further, the establishment of provisions on a pool basis, allowing the off-setting of potential losses against anticipated gains on the remaining properties, had been discussed with senior management by the auditors at 1982 year end. The auditors had understood that the properties would be evaluated on an individual basis. Eventually, bank management agreed to assess properties in Company Zero on an individual basis. The bank entered into other similar arrangements.

The auditors reported to the Audit Committee their estimate that, as of the 1984 year end, approximately $350M of the bank's loan portfolio was committed to limited recourse workout loans. These were situations in which the bank had taken control of security and entered into arrangements with new borrowers to acquire such properties, usually on the basis that the bank would provide financing to allow the new borrower to acquire the related assets.

2. Baseline Values

The concept of "baseline value" was extensively discussed in the hearings because it was an integral part of the CCB strategy. Several definitions emerged. McLaughlan testified initially that:

> First of all, you are dealing with a concept that was not widely in application within the bank in the terms of the label you are using, baseline values. It was essentially dealing with assets in a depressed marketplace, in endeavouring to determine its going concern value would be as opposed to a liquidation value, not a fair market value as you describe it, a liquidation value, a forced sale value.
>
> The term baseline value, or the label baseline value, has been blown up, I think completely out of proportion. It was simply an addition to the glossary of banking terms that we use to communicate in this particular market on what is the going concern value of this collateral securing a loan.

Gaudet, the Senior Vice-President, Special Credits, testified as follows:

> But basically baseline is an internal term that we came up with which is short sic: form for the estimated value of our security on a going concern basis. It is no more than that.

Gaudet later stated:

> ... so today when you look at properties that have decreased in value by 50 or 70 or 80 per cent because of the economics and the lack of buyers, I think it behooves us to look at the property in terms of what its real worth is, and I guess that gets us back to our so-called baseline value, which is our calculation of what those properties are worth in a real market place.

Both Gaudet and David Smith, Executive Vice-President, Canadian Credit, subsequently used the term in testimony as equivalent to "net realizable value".

By memo dated 14 September 1983, everyone in the bank was instructed to use baseline values, defined in that memo as:

> ... the price at which the asset will change hands between a willing buyer and a willing seller. The recent recession has for example caused real estate prices to fall very quickly from a record peak to well below "baseline value".

Bank officials were also required to estimate "sell-out time" which was the "time period required to attract purchases at baseline values". Further, in establishing recoverable value of assets, the time required to sell the asset was not to be discounted from the value. McLaughlan testified that the purpose of the memo was to advise the loan reviewers not to use existing (that is, pre-downturn) appraisals and not to get current appraisals as it would be "a waste of time". Instead, they were to "tell us what the security is worth and what basis you arrived at that through a comprehensive analysis":

> ... prepare the report, make it more comprehensive than the past, because we have a lot more of them [NELs]; we want a condensed analysis of each of these accounts in arriving at either the need for a reservation or not a need for a reservation.
>
> In doing that, give us far more history so we do not have to read a big file in every situation ... and, in doing that, do not rely—wake up—on the appraisals you have in your files. Things have changed drastically in the previous 6 months, is what is in that message. And, we are not going to rely on the old appraisals you have. We are not also going to go out and get our whole portfolio appraised, because it would be a waste of time. There was no market value in the fall of 1983 in Alberta, in particular.
>
> So, tell us what the security is worth and what basis you arrived at that through a comprehensive analysis which you have not given us in earlier reports. That is what the September memo is directing them to do.

Management admitted that, by the latter half of 1983, had the current value of assets been obtained, it would basically have been liquidation value in the market circumstances prevailing at the time.

The memorandum of 14 September, 1983 was up-dated on 21 August 1984. The revision recognizes that, at the bottom of a recession, value would often be based on fire sale offers and it would be the bank's preference to hold the assets pending a recovery of values to more realistic levels wherever that was considered feasible. However, the proviso was added that there would, of course, be some situations where liquidation may well be the best course.

As has been seen, CCB began to use baseline values in 1982. In a memorandum dated 28 May 1982, recording a meeting between the auditors and the OIGB, it is recorded that:

> ... Bill Kennett thought it was appropriate for banks to re-evaluate security and recognized our concern with appraised values which might indicate adequate security although there is no market at the present time. Bill suggested that banks would rightfully view the security value in the longer term and would, in a number of cases, be in a position of riding with customers and treating loans as a semi-investment. ...

The auditors discussed this matter with management in November of 1982 and also with the Audit Committee. Bank management contended that the concept of baseline value was not something new. Smith said:

> We have always looked at estimated realizable value of security in establishing reservations. That is general in the banking industry.

The question then becomes, if the practice was not new, why was it necessary to issue the memorandum of 14 September 1983. Management responded that the memorandum was issued in response to the collapse in security values which arose as a result of the recession. This was accomplished in May 1982 but apparently not on a bank-wide basis. It had been the practice of the bank to supply security evaluations based on appraisals since they were the only independent information on hand. However, appraisals taken in 1981 or 1982 were later too high in light of the recession. Indeed, during their evidence in Edmonton, management was able to show instances of baseline values below the values assigned by appraisals on file. According to management, had the memo not been sent out, reports would have shown appraised values, whatever dates those appraisals may have carried. The concept of "baseline value" was, in fact, a change from previous going concern valuations in the sense that the fundamental premise of establishing a baseline value was that there would be future economic recovery in the Alberta economy and the energy sector in Canada and the United States. The following is a statement made by the auditors in their discussion memorandum for the 1983 meeting with the Audit Committee:

> ... to the greatest extent possible, the bank attempts to maintain the going concern value of the security by taking control of the assets and finding competent new management thereby allowing time for the market value of depressed assets to return to more normal levels. We would cite as specific examples some of the real estate loans in Alberta and the drilling rig loans in Alberta and the United States. In both cases, success of the bank's strategy in avoiding major losses on these accounts is dependent upon future economic recovery in the Alberta economy and the energy sector in Canada and the U.S.

From this perspective, what was involved was indeed a going concern valuation, but with very heavy emphasis placed upon economic recovery, and values at some future time were taken into account. Therefore, the issue surrounding baseline values boils down to this: To what extent can the future economic outlook, as viewed by the valuer, be considered in establishing a property value as at the effective date of a financial statement or report?

The testimony shows that the time horizon employed in these valuations, in almost all cases, was between two and three years. The auditors testified that a time frame of three to five years would be reasonable. In one case, the bank had estimated a workout of between three and five years, and the auditor had estimated a workout of between seven and ten years, but the judgment as to the time frame of the workout was not one in relation to which the auditors could contend that they were right and the bank was wrong.

In short, both management and auditors of CCB contended that the "baseline value" method of valuation was not new in the bank, and simply reflected going concern valuations. As revealed by the testimony and documents of both these parties, the fundamental reason for the use of baseline values was the fact that security values were depressed as a result of what was perceived to be a temporary and severe recession. It is, therefore, obvious that baseline was a practice which was new because never before in the life of CCB would it have been necessary to place such a heavy emphasis on the future economic outlook. Clearly, commencing with the recession, the bank placed very heavy reliance upon the expected turn-around in the market. The bank had two alternatives: dispose of the foreclosed security in bad loans on a very weak market and suffer severe realization losses, or hold the asset through a workout process and dispose of it in a better market. In the meantime, what value should be assigned to such a loan in the loan portfolio as carried on the balance sheet? The issue is not so much whether this was a new or an old practice, but whether it was justified in light of the increasing number of troubled loans and the severity of the recession, and whether its adoption with all its consequences in financial statements would fairly represent the financial position of the bank.

The obvious problem with the baseline value approach is that the market may not recover as anticipated. Smith stated, in relation to a loan in which interest was capitalized, and subsequently some $2M was written off in the support package:

> If I could just expand a bit on that, I believe the situation was while this credit was not fully drawn at the point of this board sheet, that sometime in the not too distant future, I think a few months, this loan would have been nonearning, because we would have arrived at the baseline value. We would not go beyond that and a loan would be a nonearning loan at that point in time and *markets had not recovered to the extent anticipated* and by March [1985] we were then contemplating liquidating as many assets as we could and this was assumed to become a nonearning loan that we wanted to liquidate. (emphasis added)

3. Interest Capitalization

CCB policies allowed capitalization of interest on both new loans and problem or restructured loans after the head office Credit Department had satisfied itself about the ultimate collectability of the amount of the loan, including any capitalized interest. CCB felt that, in this respect, it was very similar to other Canadian banks. The bank capitalized and took into income interest on some loans until the loan was equal to the estimated worth of the property.

The auditors, in 1983, reported to the Audit Committee that the bank's policy of capitalizing interest on problem loans increased the difficulty in demonstrating full collectability of these loans, and the auditors returned to a similar theme in 1984, stating that the bank was somewhat more aggressive in its accrual and capitalization of uncollected interest than the auditors would prefer. In both years, as will be seen, the auditors were able to satisfy themselves that the CCB was inside the range of permissible practices. The underlying security values that the CCB would use in the decision on capitalization were, at least by September 1983, baseline values.

Similar practices were employed in the accrual of interest. Unpaid interest, ranging from 4 months to 10½ months in arrears, was being accrued on the basis that positive steps were being taken to recover amounts due by disposal of assets or injection of additional funds, or loans were being renegotiated with additional collateral. Again, interest was accrued up to the full value of the security, which was again a baseline value.

The liquidator produced CCB documents which appear to show the amount of capitalized interest in the years 1982, 1983 and 1984 for the Canadian division. These documents indicate the following amounts as capitalized interest:

1982 –	$ 2.261M
1983 –	$21.162M
1984 –	$30.460M
Total –	$53.883M

Documents subsequently put before the Inquiry indicate that U.S. figures are available as well, and that the total figure for the three years for both Canada and the United States is $59.6M (Cdn.).

CCB's study of interest capitalization was commissioned by McLaughlan on 31 May 1985 in a memorandum to bank officials.

Amounts to be included were loans funded beyond normal lending guidelines for the purpose of taking interest into revenue, which, in most cases, would require the original terms and conditions to be changed to accommodate this increased facility. Lending officers were directed to exclude several categories of loans: first-time borrowers where interest capitalization was a feature of the credit (but Newcos resulting from a restructured credit were not considered first-time borrowers), construction project loans where interest capitalization was an accepted practice, operating loans utilized to pay interest costs assuming margin conditions are observed, loans since fully repaid (repayment by a Newco/workout agreement does not qualify as an exclusion), and loans provided to cover interest arrears in which sufficient additional security was obtained to cover funds advanced.

The information, at least in the case of the Canadian division, was required by 10 June 1985. Each branch was provided with a computerized report which listed all interest payments on loans which had a funding on the same day. This report, therefore, contained potential interest capitalization entries. Each branch produced a schedule showing the name of the account, principal balance at year end, total level of interest capitalization for the year, loan status at year end (earning or otherwise), current status, and industry classification. Each schedule was signed by the regional vice-president. The regional vice-president for the Atlantic provinces advised Head Office that because the exercise was subject to some judgment, there could be imperfections in the findings of that office.

McLaughlan and Smith were recalled by the Commission to explain the CCB interest capitalization report. They submitted that the document was inaccurate but that the amounts reported for the U.S. Division could be understated. The Controller's Department, headed by Paul Melnuk, had performed testing on the document and discovered a number of errors. In addition, R.J. Pogue, of the Controller's Department, stated that his impression from the lenders in the field was that McLaughlan's definition of capitalized interest "was not very concise and left room for interpretation". Because the House of Commons Finance, Trade and Economic Affairs Committee had already delivered its report, which was the reason for CCB's interest capitalization study in the first place, no attempt was made to discover the extent of the inaccuracy or the true amount of capitalized interest within the bank.

Despite the weaknesses of the capitalization study as explained by McLaughlan, Melnuk, in a memo dated 10 July 1985, instructed that the capitalization records were to be kept on a prospective basis for the use of the OIGB, and that such records should be based upon the same criteria and instructions as were used to develop the earlier information. William H. Broadhurst, Chairman and Senior Partner of Price Waterhouse, and several bankers testified that it is not the practice of Canadian banks to record this data. They indicated that although a system could be developed to capture this information in advance, it would be difficult to capture the information retrospectively. Paine testified that if CCB's capitalization records were accurate, which he did not believe, then the auditors and the Inspector General were "blithering idiots". The total of interest capitalized, $59M, must be considered in its relationship to the bank's net income over the same period of about $16M. Any significant reversal of such an amount of interest taken into income (although no cash was received by the bank on the loans) would have placed the bank in a loss position throughout these years.

The problem of assessing the extent of interest capitalization is further complicated by evidence tendered by the auditors, who examined their working papers in relation to the loans where interest was alleged to be capitalized. They noted a number of cases where the principal balance of the loan appeared to have been reduced, or had not been increased, to reflect the amount of interest allegedly capitalized. They concluded that there are a significant number of the loans where the interest, if capitalized, appears to have been repaid. All this is reviewed in Chapter 4.

4. Nonperforming Loans and Loan Loss Provisions

CCB used a fairly narrow test in providing for a loss: a loss must be known or likely before a provision was taken. The bank's accounting for specific loss provisions tended towards the less conservative end of the range of accounting for loan losses. One result of management's approach was that a significant amount of the problem loan portfolio had been classified as earning where the same would otherwise have been classified as nonearning. Again, decisions whether to provision for an account were based upon baseline values with all the expectations incorporated therein.

5. OIGB Supervision and Knowledge

Much of the material contained in this section of the report has been presented previously in connection with the history of the CCB. In light of the Inquiry's mandate to assess the Canadian bank supervisory process, it is appropriate to review certain aspects of the narrative with an emphasis on the regulatory perspective. It sheds some light on the relationship between the OIGB and the bank that the Inspector General learned on 7 May 1981 from the Federal Reserve Bank of San Francisco that CCB had made an application to acquire a 40 per cent interest in Westlands. On 26 May 1981, the OIGB obtained by telephone from the bank information regarding Westlands, including the type of bank, size, number of branches, management, and problems in the new acquisition. The OIGB was advised that it was not the intention of CCB to take an active part in the day-to-day management of the bank; CCB was satisfied with the officers in place.

On 30 April 1982, the OIGB learned that Greymac Mortgage Corporation had purchased approximately 10 per cent of the issued and outstanding shares of CCB, and that Leonard Rosenberg, who controlled Greymac Mortgage, had been elected to the Board of Directors on 27 April 1982. In May 1982, the OIGB became aware that the bank had made a loan to Greymac Credit, a company associated with Rosenberg. This subject was to be pursued at the annual inspection. The 1982 annual inspection by the OIGB revealed nothing considered to be alarming although there was some concern about asset quality, liquidity, and overhead expenses. The inspectors found that actual loan losses and NELs had begun to rise in 1981. There was also a narrowing of interest spreads, and income was dropping off slightly.

On 3 June 1982, the Governor in Council approved an increase in CCB's authorized capital by the creation of two classes of preferred shares and additional common shares.

After 1982, the OIGB received regular reports regarding the financial status of CCB. On 19 October 1982, OIGB officials visited CCB and learned that 16 per cent of all loans were classified as MUL. The percentage of these loans had quadrupled in the past eight months. In the British Columbia and Rocky Mountain regions, MULs stood at 26 per cent of the loan portfolio. The bank's practice of interest capitalization was discussed at this time. The bank said that capitalization was done only in "exceptional" situations. The OIGB found that interest was accrued where unpaid for periods ranging from four to ten and one-half months, in situations where "positive steps" were being taken, such as disposal of assets, injection of funds, and renegotiation of loans with additional security. The Inspector General considered that the bank had a good grasp of the problems and had taken steps to correct them. However, the OIGB recognized that recovery from the recession was not imminent, and Grant speculated that uncollected and capitalized interest could overstate profits for 1982 by $5.2M. This matter was left to the auditors. In the light of the 1985 study made by the bank and produced by the liquidator, this comment takes on added significance.

A "secret" memorandum prepared by an official of the Bank of Canada and dated 6 October 1982, has previously been discussed. It stated, in part, that a representative of the Bank of Canada "called this morning to report that he has been getting a noticeable increase in comments from his contacts about the health of the Canadian Commercial Bank in Edmonton". The report goes on to state that two representatives from the Bank of Canada called on McLaughlan at CCB and expressed "some concern about the bank's exposure to a loss of confidence which might culminate into a run on the bank". The report details a loss of deposits experienced by the CCB and difficulties in oil industry loans in both Canada and the United States. McLaughlan thereupon inquired as to what the Bank of Canada's role would be in the event of a run on his bank. There is no record of any action having been taken by anyone in the OIGB from whose files the memorandum was produced to the Inquiry. Similarly there is no indication of any action on the part of the Bank of Canada although the memo indicates on its face a wide distribution throughout senior executives, including the Governor.

On 11 January 1983, the Assistant Inspector General contacted Robert Lord, one of the bank auditors, to discuss generally the lending practices of the bank. Lord stated that he was satisfied that although the bank had a relatively high volume of substandard loans, the credit people were "on top" of the situation and were being quite innovative and aggressive in seeking ways to improve individual situations. He informed the Assistant Inspector General that the regional economy had caused difficulties in the bank's forest product, oil and gas, and real estate loans. He further stated that the assessment of real estate loans was particularly difficult at the time because there was no market for the properties, but that he did not feel that the bank would be in serious trouble in its real estate lending. He was confident that the bank's review of credits would ensure that there would be no surprises in 1983, other things being equal. Grant's speculation that CCB profits could be overstated by $5.2M does not appear to have been raised with the auditors, but Grant was satisfied because the auditors attested to the fairness of the financial statements for 1982.

As early as mid-1982, the OIGB was aware of some of the accounting practices in use in the bank, and was discussing them with the auditors. At the meeting between the auditors and the OIGB during the 1982 inspection, the parties discussed loans in some detail and particularly the valuation of loan security and the practice of capitalizing interest. In response to the extremely depressed market values for real estate and drilling rigs in Western Canada, the bank valued security by taking into account the expected recovery of market prices.

This approach was considered to be justified on the basis that a liquidation approach would not be appropriate considering the depressed market conditions for securities such as real estate and drilling rigs and because of the bank's stated intention to support companies which were in difficulty as a result of the economic climate.

The auditors expressed to the Inspector General their concern about appraised values which might indicate adequate security although there was no market at the time. The Inspector General suggested that banks could rightfully review the security value in the longer term and could, in a number of cases, be in a position to ride with customers and to treat loans as a semi-investment. With respect to capitalized interest, the Inspector General indicated that it was a general practice in the industry to take a conservative approach and not recognize interest revenue that was overdue; however, each loan had to be reviewed individually. The Inspector General testified that while security could be valued in this way during recessionary times, if the gap between such a value and the current market value did not narrow on its own, the value should be written down or a specific loan provision should be established; a gap should not prevail for a very long time. This qualification does not appear in the auditors' memoranda nor in the Inspector General's documents. Indeed, it was not until July 1985 that the Inspector General recommended to Northland's auditors that some provision would be necessary on real estate as the Alberta economy had not yet recovered, rendering Northland's concept of going concern values suspect.

In late March 1983, McLaughlan informed the OIGB that 18 per cent of all loans were classed as unsatisfactory, including the noncurrent loans (as defined in s. 58 of the *Bank Act*) which represented 4.5 per cent of the total loan portfolio. In addition, 31.45 per cent of all loans were judged "more than average risk". Grant could not recall whether the OIGB ever ascertained whether these loans should be classified as MUL. McLaughlan also indicated that there had been a 60 per cent increase in unsatisfactory loans in the U.S. portfolio since September 1982. He indicated to the OIGB that 45 per cent of the loan portfolio remained concentrated in Alberta and British Columbia, and that the bank was also under funding pressures. He reported that by virtue of the Greymac Trust incident, CCB believed that it was paying a premium of 15 to 25 basis points for its deposits and that noninterest expenses had substantially increased by reason of the 1981 commitment to expansion. As a result of all these matters, and in order to relieve funding pressures, the development of new business was terminated.

In April 1983, the OIGB was advised by a third party about supposed unorthodox practices at the CCB. The office was told that the bank was transferring troubled real estate loans to special purpose companies with minimum capital, the bank advancing the funds for the purchase. The largest of these arrangements was entered into in 1982 between CCB and a corporation that was identified for the purposes of the hearings as Company Zero. An officer of the OIGB investigated the use of Company Zero thoroughly. His discoveries have been outlined earlier.

The OIGB took the matter up with management so as to gain a clear understanding of the bank's policies regarding the accounting treatment of interest on loans where no interest is being paid, and of the effects of these policies on the income statement and the balance sheet. The office also wished to determine the circumstances in which the bank would cease the accrual or capitalization of interest, and would reverse any such interest which had been taken into income. While no such policy understanding appears to have been reached, the OIGB was provided with reports on all cases where a Newco workout plan was used. The applicable policy on income recognition is discussed below. On 22 July 1983, the office informed the CCB that the office had gained a fuller understanding of the Company Zero workout arrangements, and of the bank's accounting treatment of them. The office was "generally satisfied" with the accounting treatment, but wished to keep in touch with these arrangements.

On 24 May 1983, the OIGB annual inspection of the CCB commenced. The office was concerned that the bank's inspection department did not evaluate the quality of loans in the course of their lending platform reviews, it being the bank's approach that the valuation of credits is the responsibility of the credit department and that the inspection department should limit its procedures to ensuring that bank policies are adhered to. The auditors gave their opinion that present procedures were satisfactory.

The 1983 post-inspection report indicates that the OIGB remained concerned with the following issues: capitalization of interest up to realizable value (as opposed to lending values) of security in some cases, treatment of gains and losses on the sale of property, the treatment of specific provisions (insufficiently conservative), the quality of the loan portfolio, and the lack of diversification therein. On the other hand, the office was pleased about the planning policies of the bank, about the good quality of management information systems reports, and generally about the quality of management. This post-inspection report contains no overall rating for CCB as this practice began with the introduction of the CAMEL system in 1984.

On 23 June 1983, Macpherson summarized the operating results for second quarter 1983. The bank's performance was "one of the poorest of the Schedule A banks". Current quarter results were deteriorating; net income declined by 20 per cent, and return on assets declined by 22 per cent to 0.32 per cent. Spreads had increased to 1.16 per cent. In comparison to the 2nd quarter 1982, net income had decreased by 30 per cent and return on assets had decreased by 40 per cent, even though assets grew by $255M. Loan loss provisions rose by 88 per cent, and noninterest expenses had increased by 46.6 per cent. In October, 1983, the third quarter 1983 operating results were received by the OIGB. All major indicators had dropped from the previous quarter and from the same quarter a year earlier. Net income was down 60 per cent from the previous quarter. Return on assets was down 37.5 per cent. Spreads decreased by 8.2 per cent. Loan assets, however, had grown by 6 per cent. Actual loan losses were $3.2M, against a provision of $2.4M.

In December 1983, the DBRS downgraded the CCB credit rating from R-1(low) to R-2(high). The bank expressed a concern for liquidity, and the office agreed that there was a distinct possibility that the downgrading increased CCB's cost of doing business through increased interest costs.

On 7 February 1984, the CCB reported its 1983 accomplishments to the OIGB. There had been a $19.5M common share issue by private placement. The trust company shares had been dealt with in a satisfactory fashion. The bank had successfully issued $10M in subordinated debentures and $30M in preferred shares. The bank had experienced no serious disruption in funding arising from the DBRS downgrading. Overall operating expenses had been reduced. In addition, CCB reported that nonearning loans had been reduced to $119.5M from $177M. At the end of the 1984 fiscal year, the bank expected them to be further reduced to $66.7M. In fact, by 31 March 1984, NELs had increased to $166M.

The 1984 inspection was made on 15 May 1984. The OIGB was very concerned that NELs had risen from $71.4M (1982) to $161M (end of first quarter 1984), especially since CCB had earlier projected a decline in 1984. Accounting concerns were again discussed with the auditors. The office noted in its post-inspection report that present appraised values for real estate were virtually useless in the British Columbia and Alberta markets, and that, where the bank had control of a difficult loan situation, it placed a "holding value" on the security. The auditors had initially drawn attention to this practice in 1982. In the 1983 Memorandum for Discussion with the Audit Committee they again highlighted the practice. The size of provisions against specific loans was also discussed. The auditors informed the office that there could be larger specific provisions on certain loans. Grant testified that he did not recall the auditors indicating how much larger the specific provisions should be, or upon which loans. Either during the course of this meeting, or subsequent thereto, the OIGB would have reviewed a copy of the 1983 Memorandum for Discussion with Audit Committee. Attached to that Memorandum as a schedule is a list of problem loans where additional provisions could have been justified. The additional provisions aggregate $3.36M for the Canadian Division and $13.8M in security shortfall for the United States Division. The appropriations for contingencies account stood at $24M, and the auditors took the view that this represented additional protection on unforeseen loan losses. Grant was, therefore, satisfied that the provisions, plus the capital of the bank, plus the appropriations for contingencies account, were sufficient to cover any losses that could be incurred.

The auditors also discussed the concept of going concern security valuation, and informed the OIGB of the auditors' heavy reliance upon senior management decisions relating to specific loss provisions and when to cease accrual of interest. A list of interest capitalized on problem loans was also attached to the Memorandum for Discussion. The schedule amounts to $6.578M, and indicates capitalization on soft, nonrecourse financing. In one case, interest was capitalized in relation to baseline values, and, in one other case, interest was capitalized after a settlement offer was received by the bank. In 1983, the net income of the bank was $6.505M.

In the post-inspection report prepared by Watt, the bank was rated satisfactory. Grant, who had more experience with CCB, rated the bank unsatisfactory; however, the written report was never changed to reflect Grant's views. The Inspector General advised the Minister by letter dated 24 September 1984 that the bank's profitability had been adversely affected by nonperforming loans and the need to make provision for loan losses. The letter did not actually reveal that in the opinion of the Director of the Inspection at the OIGB the bank was in an unsatisfactory condition. Indeed, the letter concluded that "the bank is in sound financial condition". Furthermore, the letter attributed the poor performance of the bank in fiscal 1984 to the need to absorb losses related to its 39 per cent interest in Westlands. By the time of the letter, Westlands had become a wholly-owned subsidiary and no mention was made of the magnitude of the loss absorption in CCB thereafter. It is the position of the Inspector General that the format of the letter would reveal the opinion of the OIGB that the bank was in an unsatisfactory condition.

On 9 October 1984, the 1984 third quarter results were received by the OIGB. NELs now stood at $175.6M, and the level was estimated to be $183M by year end. In February 1984, CCB had predicted NELs would be down by year end to $66.7M. Loan loss experience was escalating; the estimated annual loss was one per cent of eligible assets, up from 0.72 per cent for the same period the previous year. The bank reported a profit of $2.1M, after income tax recoveries. In December 1984, the 1984 fourth quarter results were received. The bank reported a loss before taxes of $5.3M due mostly to the drag created by the Westlands Bank.

The OIGB remained concerned through the end of 1984 about CCB's security valuation, and of the problems inherent in assessing CCB. An example is a memo written by Grant, directed to the Inspector General and the Assistant Inspector General, dated 18 October 1984:

> We in the Inspection Division, and I am sure you are also concerned from a prudential viewpoint about the valuation of property generally in Alberta. However, as we know the problem with valuation in Alberta is dreadfully difficult. [name deleted] letter appears to highlight this matter even further. He believes ... that some of the properties are overvalued and others undervalued. Presumably the bank obtained a professional appraisal on these properties. In our discussions with banks and their auditors about properties in Alberta one gets the view that there can be a significant range of values depending on certain assumptions.

By an Addendum to the Non Performing Loan Paper dated 18 June 1984, the OIGB's views on the definition of nonaccrual loans were crystallized as "loans on which interest is not being accrued due to the existence of reasonable doubt as to the ultimate collectability of principal or interest". The directive requires that where interest is "contractually past due 90 days these loans are automatically to be placed on a nonaccrual basis, unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal or interest". The effective date for the implementation of this directive was 1 November 1984, that is with respect to fiscal year 1985 in all banks. In the directive, the Inspector General also expressed the intent that loans "where interest is contractually in arrears 180 days be classified in nonaccrual status ..." because such estimated nonpayment constitutes grounds for doubting the borrower's ability to repay the loan. Some elasticity was permitted, however, "only in extenuating circumstances" past the 180-day line. This directive, in dealing with restructured and renegotiated loans, however, does not clearly catch transactions such as those involving a Newco. Where a loan has been stripped of its nonaccrual status by interest capitalization or otherwise and set running again under the auspices of a Newco, the directive should require the disclosure of such transactions in a table of prescribed returns. However, the Inspector General stated in the paper that "the restructured loan definition will usually apply for large ... loans where more than one bank is at risk". There is also nothing to suggest that the definition covers workouts using new borrowers.

By a further term, these guidelines provided that all interest previously recorded but not thereafter collected was to be reversed in the quarter in which the loan is reclassified as nonaccrual. The rigorous application of this directive would have had serious implications for the accounting profitability of the CCB. Finally, the directive dealt with the accounting treatment for fees received by a bank at the time of a restructuring of a loan. The directive permits the recognition of these fees as income to the extent that they offset costs and expenses associated with the renegotiation of the loan. Otherwise such fees were required to be amortized over the term of the loan.

On 22 January 1985 and on 4 February 1985, the OIGB received first a preliminary prospectus, and then a final prospectus regarding the bank's merger with CCB REIT, an unincorporated trust. In connection with the prospectuses, the auditors supplied a comfort letter to the effect that they had no reason to believe that the financial statements contained in the prospectus did not present fairly the financial position as at 31 October 1984. The OIGB did not require disclosure of its own "unsatisfactory" rating assigned to the bank (but not disclosed to the bank) after the 1984 inspection. The final prospectus, in the view of the OIGB, contains no statements that would alert a reader to the material changes that occurred in the CCB loan portfolio in 1985. The Inspector General accepted this prospectus for filing on 4 February 1985 and issued a receipt on 6 February 1985. No reference is made to the report from the Federal Reserve Bank of San Francisco regarding the L.A. Agency which did not come to the attention of the Inspector General until mid-February 1985. It was received by CCB in Edmonton on 12 February 1985 and about 6 February in Los Angeles.

On 6 March 1985, Grant expressed his concerns about the viability of the CCB. NPLs at fiscal year end 1984 stood at $194.2M. First quarter 1985 earnings were unsatisfactory, the bank having produced an after-tax profit of $200,000. Economic conditions in the West continued negative. At this point, Grant concluded that the cost of carrying the NPLs was well in excess of earnings. The bank would, in his view, be hard pressed to survive in its current form. In a memo of 6 March, Grant advised the Inspector General that he did not believe the bank could continue as presently structured. Some time after 8 March 1985, the OIGB received a report that NPLs as at the end of January 1985 stood at $292M. The Auditors' 1984 Memorandum for Discussion with the Audit Committee, received by the OIGB on or about 7 March 1985, outlined continuing practices at CCB which distorted the financial statements.

6. The General Decline of the Bank

The beginning of 1982 marked a period of financial difficulty for the bank. The record shows a rising trend for NPLs and MULs, and the record is punctuated with examples of the OIGB seeking from the bank explanations regarding specific loan transactions, and seeking from the auditors their impressions as to lending practices of CCB. The OIGB was receiving regular reports regarding the financial status of the bank from McLaughlan. The Assistant Inspector General analyzed the operating results for the bank on a quarterly basis and was tracing the major indicators, which were dropping. In June 1983, he noted that the bank's performance was "one of the poorest of the Schedule A banks". The OIGB was aware that the MULs, NPLs, and NELs were rising, even though the bank had predicted a decline of NELs in 1984. The office was also aware of various workouts undertaken by the bank, and that the bank was not conservative in booking loan provisions or in recognizing interest.

Grant and d'Entremont visited CCB on 29 October 1982. At that meeting, Grant reported that the officers were assured that "the collateral values shown were rock bottom" in response to a question by the officers about the narrow margin of collateral value over outstanding loans in a number of instances which could result in losses for the bank if there existed a slight error in appraisal of collateral values. The officers also reported that CCB assured them that capitalization of interest was done only in very exceptional situations where the bank was convinced that it would be temporary and that cash flow from another source would correct the situation. Yet the office was also informed that unpaid interest, ranging from four months to ten and a half months in arrears, was being accrued on the basis that positive steps were being taken to recover amounts due by disposal of assets or injection of funds, or loans were being renegotiated with additional collateral. While the bank believed that it had identified all the weak situations and that rising levels of troublesome loans would be halted, the officer wrote:

> We are not so optimistic. The solution to the problem is not in their hands. While lower interest rates will certainly help some of their customers there is no evidence that recovery from the current recession is imminent. If the decline in corporate profits and the pace of corporate failures continue we cannot see how the bank can isolate itself from these effects.

> **Finally, based on information obtained from the bank it could be argued that this year's profits will be overstated by some $5.2M due to uncollected interest taken into revenue ($4.2M) plus capitalized interest ($1M).**

There is also evidence that the OIGB was aware of the bank's practices in the capitalization of interest. The practice was discussed in relation to Company Zero in 1983. In a letter from David E. Smith, dated 7 June 1983, to an officer of the OIGB, it was stated that the bank ceased to accrue or capitalize interest once the loan approximates the estimated realizable value of the security. Further, it was reported that interest capitalized on the Company Zero account aggregated $208,940 in fiscal 1982 and $519,146 in the first half of fiscal 1983. The 1983 post-inspection notes also reveal discussions on the following matters:

1. The OIGB was concerned with the high amount of unproductive loans and the bank's ability to monitor them. Problem loans appear to be well monitored, although the amount of interest capitalized appears high.
2. Except in exceptional circumstances, capitalization of interest was being made up to current realizable value and not loan values.
3. Banks' provisioning policy may not be sufficiently conservative, since the bank has a low ratio of provisions compared to other banks. The auditors were also concerned.
4. Uneasy at the amount of loans secured by land, because of falling values.

Further, as of the 1983 inspection, the OIGB extracted agreement from the bank that accrual of up to 100 per cent of security value was too aggressive and would increase exposure dramatically, but extracted no undertaking from the bank that it would change its practices. The only undertaking obtained from the bank in this regard related to being notified of any further arrangements similar to Company Zero, and there is no evidence that the bank did not comply with this undertaking.

The pre-inspection notes for the 1984 annual inspection also demonstrate that the OIGB was not satisfied with the answers it was receiving from CCB. The office again planned to ascertain during the inspection "whether the bank has a proper handle on the quality of their portfolio". The OIGB was again planning to determine bank policy regarding reversal of interest, accruing of interest, and capitalization of interest. Indeed, it appears that the OIGB was very concerned about capitalization of interest. The pre-inspection notes contain a list of capitalized interest aggregating approximately $2.48M for the period from the end of fiscal year 1983 to the first quarter of 1984, which did not include costs capitalized of $5.725M. The office speculated that profit was overstated in the first quarter of 1984 by 36 per cent.

The post-inspection notes for 1984 again outline the concerns of the OIGB: the large amount of nonearning loans, the bank's ability to properly monitor them, the bank's practices regarding accruing and capitalizing of interest on certain problem loans, and decreased profitability. The OIGB was aware of the contents of the auditors' 1983 Memorandum for Discussion with the Audit Committee, the contents of which have been outlined elsewhere. That section of the post-inspection report dealing with the concluding interview with McLaughlan states: "The bank's accrued interest and nonperforming loans are still a worry to us."

Finally, the OIGB received a copy of the 1984 Memorandum for Discussion with the Audit Committee on 7 March 1985, which again illustrated the accounting practices in the bank which would have an impact upon any decision to bail out this bank. At around the same time, on 6 March 1985, Grant concluded that it would be difficult for the bank to survive in the absence of a merger or write-off of nonperforming assets combined with a substantial capital injection.

In the last fiscal periods of the bank the OIGB gradually increased its awareness of troubles in the bank and while concern mounted, the disclosure of the crisis on 14 March was largely unanticipated. Testimony given by the Inspector General seems to indicate an uncertain hope that the condition of the bank would ultimately improve:

> Clearly, the conclusion is that the bank is struggling, that its earnings are marginal and that it needs close supervision. That is, indeed, what this is all about and what this suggests what we were doing. We were revisiting the bank every quarter ... although it was struggling still, the trend was not all that clear that it was getting worse, at least considerably worse, ... but in fact, for one reason or another, a bank ends up with a difficult portfolio, a portfolio that is full of trouble, there is no magic that will make it disappear. You either write it off in an orderly way or you work with the companies involved in the hopes that the workout arrangements will salvage value and will restore the bank to health, and that is where we were.

Further:

> While, as I have said before in the commission we have no magic. We were discussing regularly with the bank, its condition, the procedures it was following; we were improving our accounting processing in the handling of nonperforming loans but regardless how you handle them they are still there; they are on the books of the bank and they are either earning or nonearning in some real cash-flow sense. But, finally, we were hoping and expecting, as the

bank was and as other observers were, that this economy would turn around and the problems, finally the most severe problems, would be short-lived. It turned out that the economy did not turn around ....

Appendix D

The Support Program and the Collapse of the CCB

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Appendix D

The Support Program and the Collapse of the CCB

A. BACKGROUND

1. Management's Outlook at the Outset of 1985

At the outset of the bank's 1985 fiscal year, CCB officials reported a comparatively optimistic outlook on anticipated performance based upon their assessment of the overall economic environment and on internal factors. "The bank is anticipating a marked earning or improvement in fiscal 1985, although acceptable levels of profitability will not be reached until 1986 as a result of continuing but reducing high levels of nonearning loans and loan losses." Within the drilling rig sector, where a major part of CCB's U.S. activity was carried on, the fiscal 1985 outlook suggested "continuing improvement". "We were quite pleased with the performance of the drilling rig clients in the bank", and "the bank's drilling rig support program was delivering the planned results." Industry publications, and a Standard and Poor's survey dated 20 December 1984, support the suggestion that prospects for the U.S. energy industry were viewed favourably at this time. In testimony before the inquiry, CCB indicated that for the first quarter of 1985, overall financial performance actually exceeded the budget forecast, although the mix of taxable and tax exempt income differed from internal projections. Nevertheless, there were signs within CCB's U.S. division by 10 December 1984 that certain accounts were potential candidates for specific reservations in 1985. E.J.D. Pinder, Divisional Vice-President, Special Credits, estimated the requirements for specific reservations at $7.15M, $26.60M and $45.15M on a "best", "middle" and "worst" case, respectively. He stated in a memorandum of 10 December 1984 to Heisz:

> These numbers are not put forward in this format for shock effect as it is clear totals of the Best, Middle and Worst columns are not meaningful in and of themselves ...
>
> What is clear at this point is that some of our "old" names ... will require reservations this year and we should begin to factor this reality in our planning.

Concentration on the state of U.S. energy loans in late 1984 presents a somewhat distorted view of the total CCB picture. The bank had many other problems, and some were older and more serious. CCB's U.S. energy loans were under the direct management of the United States Special Credits group whose members tracked these accounts on an almost daily basis, and maintained frequent contact with borrowers and others familiar with the industry in order to keep informed of ongoing developments. Heisz reported several significant developments in the energy sector to senior management on 30 January 1985. Minutes of the meeting in which Heisz participated by phone read in part:

> The Comptroller of the Currency (Federal) in the U.S. has called on major banks to set aside additional reserves on loans related to the oil industry.
>
> Due to the falling OPEC prices U.S. companies are discontinuing development projects in the continental U.S. and Alaska. Heisz is very concerned about the U.S. Division's oil rig loans; there could be substantial additional write-offs in this area.

It should be noted that the U.S. regulator was calling for additional reserves, the earlier reserves having been required some two years earlier. CCB officials regarded the 30 January OPEC pricing decision as "reasonably good news" in that the posted price per barrel fell only $1 (U.S.) to $28 (U.S.), despite earlier predictions of price slashing. Nevertheless, in the light of continuing uncertainty about future oil prices, and other factors affecting the industry, the Special Credits group undertook a further reassessment of the bank's energy portfolio in mid-February.

Early in February, McLaughlan continued preparations for CCB's response to a U.S. FRB report on the Los Angeles agency, made after an inspection in October 1984, but effective 30 September 1984 (the bank year end in the United States). The report had not yet been received but was expected to require further reserves. In a memo to Heisz, dated 6 February 1985, McLaughlan wrote:

> While I have not yet received the most recent examination report, we do know that the Fed rated a large number of loans doubtful that will necessitate the provision of reserves. We now must determine how we will handle this situation, i.e. should the loans be transferred to Canada without reserves or should we book specifics and eliminate the reserves on our consolidated results. Please discuss this situation with P. Melnuk to ensure the strategy we adopt will be the most acceptable to our external auditors.
>
> In future, you should systematically conduct loan portfolio reviews of Commercial Centre Bank and CCB Agency to ensure borderline accounts are transferred to Canada prior to regulatory examinations.

This would seem to indicate that CCB found U.S. bank regulators more demanding than the OIGB. An overview of the energy portfolio reassessment, given to McLaughlan on 23 February, and presented to him in detail in California on 27 February, suggested an impact on the U.S. oil and gas industry that McLaughlan describes as "pretty sudden and pretty severe" in comparison with recent positive forecasts.

The report by Heisz presented a very negative picture of the current situation in domestic and world markets:

> While modest progress had been achieved in the Bank Sponsored Workout Program for specific contractor clients, it is clearly evident based on the current energy industry that times are getting worse and more setbacks are expected for energy-related companies and banks. During the 1982-83 era, most oil companies believed that by 1985, oil and gas prices would rise due to demand and supply factors improving the domestic markets. Instead, world market conditions have deteriorated which has caused the future to be bleak for refiners, distributors, drillers, and others in the energy chain. Since late 1984 to the present month, the oil-price set back has been another stiff blow for the staggering U.S. oil industry. Ebbing demand and OPEC's inability to deal with underselling and the oil glut have driven spot prices for the key U.S. crude oil to about $26.00 a barrel. Values of most reserves have again fallen dramatically and other oil-related assets have too, with some drilling rigs bringing 11 cents on the book value dollar recently at East Texas bank auctions. Drilling activity has dropped more sharply since mid-December 1984 than at almost any time in history, dooming many bankrupt operators who have been barely alive since 1982.

In fact, oil prices after taxes in Alberta had dropped in late 1980, and a world-wide decline in the oil industry came in late 1981. At approximately the same time as the Special Credits review of the U.S. energy situation was being carried out, other indications were emerging within the CCB's U.S. division that the problems in the bank's loan portfolio extended outside the energy sector.

McLaughlan testified that prior to 23 February, he was satisfied with improvements in the U.S. energy portfolio. After receiving the report on 27 February 1985, McLaughlan determined that further capital investment in the drilling rig support program would be an unacceptable business risk, and accepted the recommendation of the U.S. division that the portfolio would go into liquidation later in 1985 as contracts were concluded. For the CCB, as recognized by McLaughlan at this time, there would be a two-fold impact. First, to write the drilling industry loans down to liquidation value would involve a major charge against the bank's capital through the appropriations account, then estimated to be about $85 million and equivalent to about 70 per cent of CCB's capital. Second, a substantial increase in nonearning loans in the U.S. energy portfolio was anticipated. The estimate of approximately $100M in new nonearning loans would result in a further charge against earnings, an expense that was expected to be in the vicinity of $10M at a time when the annual earnings forecast was in the $4.5M range. The impact of the write-offs would be felt on both assets and earnings of the bank. The loss of interest revenue resulting from loans becoming nonearning would be a further blow to the income statement.

On 4 March 1985, the Loan Committee of the CCB Board met. Committee members were told that management expected to suffer a loss of $85M on the U.S. drilling rig loans. In addition, MULs within the bank were rising, the increase being mostly due to increasing NELs. The Loan Committee took no action as the same report was to be made to the Board of Directors the next day. On 5 March, an executive summary of the report was tabled at the meeting of the Board. Although the Board minutes do not reveal any reference by the President to the existence of the Heisz Report on the proposed write-off of $85M (Cdn.) on U.S. drilling loans, the executive summary paraphrases the Heisz report without revealing its existence. The summary noted "a sharp increase in NELs" and stated that "the outlook for the energy services sector has suddenly turned very negative". Crude prices had experienced an "overnight precipitous drop" and the quality of the BSDP loans "is eroding". McLaughlan's notes indicate that "the analysis is not completely definitive at this stage" and, according to the minutes, the President concluded with the statement: "If the U.S. energy services sector continues to deteriorate and liquidation is ultimately pursued, additional capital would be required later in the year."

CCB's Chairman, Paul Britton Paine, advised the Inquiry that the presentations had a quality of "iffyness" and that directors were anxious to determine "to what degree was this a reality, a current reality, or an apprehended future state of affairs". Paine testified that no reference was made to the Heisz Report as such in the Loan Committee meeting or the Audit Committee meeting of 4 March, or in the Board meeting on 5 March. Indeed the Heisz Report dated 25th February was not seen by the Chairman until some time after the month of March. He stated in evidence:

> My clear impression was that this [the Heisz Report] was absolutely new startling evidence. This is one of the reasons — I cannot speak for the rest of the Board but I think it was their impression as well — that we said as a group, 'Go away and find some hard facts and get back to us within two weeks so that we know where we are at'. ... I was unaware of it [Heisz Report]. It was a long time after, I think in preparation for this Commission, that I first saw it.

It is not without significance that the Heisz report itself was never presented to the Board or to the OIGB, yet management based the crisis which led to the revelations to the OIGB and the Bank of Canada on 14 March on the U.S. energy loan deficiencies revealed for the first time in the Heisz report. The Board in the end directed management to appraise the entire loan portfolio and to report back to the Board on the 19 March. As will be seen below, the Chairman of the Audit Committee had become aware, while visiting the Los Angeles Agency in mid-February, of troubles in the U.S. energy loans. As will be discussed shortly, the CCB also received in February a seriously adverse report from the FRB on the L.A. Branch. This report also was not revealed to the Board at the meetings of 4-5 March. Mr. J. Hillman, the Chairman of the Audit Committee, was aware of the report.

The Board, in its meeting of 5 March, and before any discussion arose as to the "U.S. Division nonearning loans" and nonearning loans in general, passed a resolution declaring a dividend. This decision was rescinded on 17 April.

McLaughlan stated, with respect to these events, that there was no doubt in his mind that the action directed by the Board was a review of the balance of the bank's loan portfolio less the U.S. energy loans which had already been appraised and reported upon to the Board. He further testified that this report was to be ready for the meeting of 19 March, and that in the meantime, he was to speak with the Government of Alberta and the Inspector General of Banks to disclose this problem.

On 13 March 1985, CCB's Canadian Banking Division completed a detailed analysis of the entire loan portfolio with a view to quantifying the extent of write-offs necessary to reflect current market conditions, and the impact of those conditions on the level of nonearning loans and partially earning loans over the planning horizon to 31 October 1987. On 14 March 1985, the United States Division completed a similar review. This material was presented on 17 March to a Special Committee of the Board which had been struck to review the problem. These analyses indicated write-offs totalling $252M on a "probable case" basis which were expected to occur on 30 April 1985 ($111M Cdn.) for the U.S. Division, and on 31 July 1985 ($141M) for the Canadian Division.

In his capacity as Chairman of the Audit Committee, Hillman planned to attend the offices of the Agency in Los Angeles between 11 February and 13 February 1985 to observe the inspection systems and controls which had been implemented at Westlands. Although a review of the loan portfolio was not planned as part of his agenda, Hillman did receive information from Boynton about the general condition of the U.S. portfolio. A draft report of Hillman's visit, prepared some time after his return (he did not report to management or the Board Chairman on his return except as to any remarks he may have made to the Committee and Board meetings on 4-5 March), discloses that the following comments and concerns regarding the quality of the loan portfolio were expressed to him by senior staff in the Agency:

1. tend to push problems forward on existing portfolio through accounting techniques such as interest and expense recapitalization;
2. creating borrowers;
3. lending platforms not quick to identify early symptoms of problem loans, reflecting the mixed calibre of loan officers and regional vice-presidents, and their natural tendency not to report trouble on loans they negotiated;
4. nonearning loans are worse than the directors understand them to be;
5. substantial reservations required on the portfolio;
6. reviewed the just received Federal Reserve letter of February 6, 1985, transmitting the report of the examination and commenting specifically on asset quality.

Hillman testified that he did not hear, during this visit, about the Heisz report which was in preparation at this time, nor was he informed of a sudden deterioration in the bank's drilling rig financing program. Hillman's notes from the visit contain no reference to suggest that these subjects were mentioned to him. Apparently, Hillman did not seek out or report upon specifics of the amount of write-down necessary in the U.S. portfolio as he considered this was a matter to be dealt with through the Chief Executive Officer of the bank. He returned to Canada on 13 February and arranged to meet with McLaughlan on 4 March 1986. Hillman for reasons unexplained brought back only the covering letters for the FRB report, but not the report. This report was very critical of the L.A. Agency. There is no evidence that Hillman advised the Loan Committee or the Board of this report at the 4-5 March meetings.

2. First Knowledge in the Executive Branch of Government

a. Pre-March 14 Information in OIGB

Information on the condition and affairs of the CCB prior to 14 March, the date on which McLaughlan met with regulatory officials in

Ottawa to report serious deterioration of the bank, was available to the OIGB from three sources: telephone calls from McLaughlan, a report by U.S. regulators concerning the California operations of the CCB, and the regular monitoring of the CCB conducted by OIGB personnel.

(i) McLaughlan Phone Calls: In early to mid-February, a meeting between officials of the OIGB and CCB representatives was scheduled for 14 March 1985 for the purpose of discussing CCB's 1985-1987 strategic business plan, its 1984 financial results, and the 1985 first quarter performance. Macpherson explained that a meeting in some form for routine purposes was actually contemplated as far back as November. McLaughlan has testified that he phoned the OIGB on 11 March to advise that the CCB energy loan situation and possible solutions should be added to the agenda. McLaughlan has testified that, after learning that the Inspector General and the Assistant Inspector General were absent, he spoke with Brossard, Director of Compliance at the OIGB and, "explained to him very briefly the new topic" and "just mentioned to him quickly" the three alternatives: recapitalization, merger, liquidation. McLaughlan testified that in a follow-up call on 12 March he spoke again with Brossard to identify possible merger candidates.

McLaughlan's communication with the OIGB took place about two weeks after he learned of Heisz' conclusions from the U.S. energy portfolio review. McLaughlan accounted for what appears to be a significant delay in advising the OIGB of changed circumstances by emphasizing his desire to assess the problem more fully himself: "I did not see any merit in a few days of hollering 'fire' when I did not know the magnitude of the potential solutions that were being considered." McLaughlan similarly explained his failure to refer to the sudden deterioration in the United States energy portfolio when he wrote Grant on 7 March, enclosing the report of the FRB on CCB's L.A. agency, although he knew of the California energy loan study on 23 February 1985 and was aware of its basic conclusions by 27 February 1985. It reported the need to write down these loans in the amount of $85M (Cdn.) which would represent a loss of about 70 per cent of the bank's capital.

The picture is further complicated by a memorandum prepared by the Bank of Canada on 8 March 1985 (discussed below) in preparation for the 14 March meeting. There is no explanation as to how or why the Bank of Canada had become involved in a meeting which all parties said was "routine" at least until McLaughlan expanded the agenda by his calls to the OIGB on the 11 and 12 of March. The 11 and 12 March phone calls do not appear in a chronology of events prepared by the

OIGB. The Inspector General testified that Brossard remembers only one call, around the 11th of March, and that Brossard recalls nothing in that call that particularly raised his concern or provided new information for the forthcoming meeting. Brossard testified on this matter in the Senate Committee hearings:

> As I said, the whole purpose was to confirm whether the meeting on the 14th was still on. I confirmed that the meeting was lined up and that the people who he wanted at the meeting would be there. It was a very short conversation. He did mention in confirming the meeting that the purpose would be to discuss the situation of the bank and that he thought the bank was in some difficulty. We agreed that we would discuss these matters on March 14, that that was the purpose of the meeting.

It should also be observed that the Inspector General was scheduled to be away at the time of the meeting on 14 March. This was known to McLaughlan but he did not ask that the Inspector General be alerted to the fact that the meeting would be faced with serious issues requiring the presence of the Inspector General himself.

(ii) FRB Calls of 15 and 20 February, and Report: FRB in Washington called the Inspector General on 15 February to express general concern about the condition of the CCB's U.S. Agency and to arrange further talks on the matter. The concerns of the FRB in Washington were based on a report received in Washington in early February. That report was based on an examination of the CCB's U.S. Agency carried out in October 1984 with reference to the financial position at 30 September 1984. This report, therefore, did not deal with the question of the U.S. energy portfolio.

The Inspector General called McLaughlan on 15 February at the CCB where the FRB report had been received on 12 February. Kennett described the information he received from McLaughlan as "rather upbeat". During the course of a later conference call on 20 February, the FRB advised the OIGB of its assessment of CCB's portfolio. The FRB classified about $100M of loans as unsatisfactory, including $40M rated doubtful. As a regular practice, the FRB expects doubtful loans to be written down by 50 per cent. The Inspector General understood that the FRB expected CCB to make a significant write-down in the U.S. Agency's loan portfolio. It was also indicated to the OIGB that "The Fed is considering that it may soon have to take some action". The OIGB requested a copy of the FRB Report which it received from the CCB on or about 7 March.

In testimony before this Inquiry, the Inspector General indicated that the 20 February FRB call did not produce a sense of urgency or suggest the need to embark upon a thorough examination of the CCB's loan accounts: "The call on 20 February did not, in any sense, create such apprehension that it would have required that kind of response." The Inspector General did not consider that the U.S. regulator's concern was "terribly high", and concluded that it was "not rushing desperately to act in these circumstances." As the Inspector General explained: "Well, it was not so alarming to the U.S. authorities that they got it to us on October 1. This was well into February. It was the first time they had been talking to us about this, and they were quite happy to have us discuss this matter with the bank and sort out a response on March 14". Reassurances from CCB based on detailed loan review, in contrast to the FRB's "broadbrush approach", and the age of the FRB assessment, it was said, supported the OIGB's view of the 20 February information: "It was not a matter of the greatest urgency and it was never regarded by us as being a matter that would bring down the bank." This is ironic as it was the position of CCB that the condition of the L. A. Agency loans forced the bank to seek aid in Ottawa on 14 March 1985. The Inspector General's comment is inapt for another reason. A memorandum prepared on 21 February 1985 concerning the call from the FRB on 20 February revealed, according to Kennett's testimony, that the FRB was concerned not only about the condition of the L. A. Agency but also about the effect of its bad loans on the entire bank.

The Minister of Finance has expressed the view that it is difficult to conclude clearly that more active measures should have been undertaken between 20 February and 14 March. "I think that the opportunity was there within a fairly short period of time for the Inspector General to get the whole picture together as opposed to simply looking at the California problem."

This does not take into account the following facts: this significant report had been in the hands of CCB head office since 12 February and the Inspector General had been notified by the FRB on 15 February of its adverse report; there was a general background of trouble, dating back at least to the May 1984 inspection of the bank by the Inspector General after which Grant, the Director of Inspection, graded the bank's condition as unsatisfactory; and Grant had written a memo to Macpherson on 6 March in which a merger was considered. None of this led to any special preparation for the 14 March meeting, or even to the inclusion in the agenda of the California report and the rising NELs in the bank, or its falling earnings. The meeting remained in the "routine category" because, while the OIGB considered that the bank might not survive indefinitely in its present form, the office assumed that CCB had months, and possibly years, to seek solutions to its problems.

The FRB report and the Heisz report reached CCB at the same time but the purport of the latter only reached the OIGB in the meeting with McLaughlan on 14 March. Management did not appear anxious to acquaint either its own Board of Directors or the OIGB with these two serious reports at the same time.

(iii) Regular Monitoring Post-1984 Fiscal Year End: The third source of information concerning the condition of the CCB was the regular monitoring, surveillance, and reporting practices of the bank inspection system. The Inspector General prepared for the Minister of Finance the following outline, dated 25 March 1985, of indications of difficulties prior to 14 March 1985:

> The key indicators used in following a bank are quarterly earnings, the level of nonearning loans and the level of loan losses.
>
> During 1984 the CCB presented an erratic earnings performance, earning money in the first and third quarters and losing money in the second and fourth.
>
> The Bank indicated ahead of time that the second quarter would be a loss and explained that this was due to loan write-downs in Westlands Bank located in Orange County, California. CCB then owned a minority interest in this bank.
>
> The third quarter results were profitable and acceptable given the Bank's burden of nonearning loans. They were also as we had been led to expect by management.
>
> Fourth quarter financial results were made available about the turn of the year and were disturbing as they were a loss and off expectation. Management indicated that unanticipated further write-downs had been taken in Westlands Bank which had become a wholly-owned subsidiary of CCB. Non earning loans continued to be a concern but it appeared that the Bank was able to carry them.
>
> Given our concern with the fourth quarter result, we began in February 1985 to seek indications of the results of the quarter ended January 31. We learned that nonearning loans had increased in the quarter and the quarterly results would be affected by this.

Grant had been directly involved in the follow-up of the auditor's report for the 1984 fiscal year. He expressed increasing concern with the state of the CCB following receipt of the first quarter 1985 results and the FRB report: "In the first quarter of 1985, when I learned that their profitability was rather marginal — about $200,000 — this concerned me more, and coupled with the call which we received from the Fed, I thought that I should look somewhat more closely then at what was going on." On 6 March, Grant wrote Macpherson to outline the basis for his concern and the possible options including merger and restructuring which he had begun to examine. On the following day, 7 March, the post-audit letter dated 1 March and accompanying materials, including CCB's comments on the auditors' findings and the FRB report, were received by the OIGB. Grant had requested the post-audit letter from the CCB on 11 January and again on 25 February.

The auditors, in a post-audit letter dated 1 March, indicated that CCB was "somewhat more aggressive in its accrual and capitalization of uncollected interest than we would prefer." Their report also stated:

> The recovery of a number of large credits would be endangered if the expected recovery in the Canadian and U.S. economies does not continue. They could also be endangered if the general level of interest rates was to rise significantly. Further, the Bank is exposed on several loans where the ultimate collectability depends on a significant recovery in the Alberta and British Columbia economies and in the energy sector in the U.S.

From the various sources of information available to it, the OIGB was aware that the CCB's condition was not strong. The OIGB concluded, however, on the basis of information from the auditors, CCB management and the FRB report dealing with the U.S. Agency, that the situation was not solvency-threatening.

b. Pre-March 14 Information Available to Others Within the Federal Executive

Governor Bouey testified that prior to 14 March, the Bank of Canada had no indication of current and acute problems at the CCB, although on the basis of contacts with the OIGB and from annual reports, Bank of Canada officials were aware that CCB was struggling and having problems. Vachon also indicated that McLaughlan's presentation on 14 March came as a surprise. However, about one week before the 14 March presentation, the Bank of Canada had received a general indication that in the view of the OIGB the future of the CCB was uncertain. A memo from Vachon to Governor Bouey, dated 8 March, states in part:

> The Office of the Inspector General of Banks has doubts about the long-term viability of the CCB given its present structure. These doubts stem mainly from the large portfolio of nonperforming loans, totalling some $220M. These loans, in turn, reflect the bank's exposure to the real estate sector in the western provinces as well as to energy sectors in Canada and the United States. The latter loans appear, in part, on the books of the CCB's agency in California. The large portfolio of doubtful loans has, to date, entailed an annual shortfall of revenue of some $18M and has been largely responsible for the bank's negative earnings performance (before tax credit) over the past several quarters. Given the rather bleak outlook for the real estate and energy sectors in both Canada and the United States, it is likely that the loan portfolio will continue to represent a drain on the earnings of the bank and undermine its ($150M) capital base. The Inspector General fears that a

> continuing negative earning performance could eventually undermine depositors' and investors' confidence in the bank and bring about the need for liquidity support from other chartered banks or the Bank of Canada, or both. Thus far, the CCB does not appear to have experienced any unusual funding difficulties.

This memorandum makes no mention of Grant's memorandum of 6 March which concluded that "the Bank will be hard pressed to survive in its present form." In tone, the two memoranda are remarkably similar. The Minister of State (Finance), also testified that she had not been alerted in what she describes as "any particular sort of danger-signalling sense" to developments at the CCB subsequent to an initial briefing in October 1984. There is no indication that the October 1984 briefing acquainted the Minister with the fact that the Director of Inspection for the OIGB had concluded, following the 1984 annual inspection, that the CCB was in an "unsatisfactory" condition or that she was advised as to the state of the CCB loan portfolio as then known. Nor was this information presented in the Inspector General's annual reporting letter on CCB to the Minister of Finance. Prior to 14 March, the Minister was familiar with the California branch of the CCB as a significant part of the bank's operations but not aware of the 20 February FRB telephone call or that the California situation might bring down the CCB. The Inspector General has confirmed that at meetings with the Minister of State on 5 February and 25 February he did not advise her of current discussions regarding the CCB: "Nothing had happened in that period that I considered to be so significant that I had to seek a special arrangement, a special meeting to inform her." The 25 February meeting between the Inspector General and the Minister of State dealt with "other subjects related to reworking of the financial system".

Similarly, it is the recollection of the Minister of Finance that the CCB California situation first came to his attention in mid-March: "I was made aware of the problem I believe the first time over the course of the weekend in Quebec City; that was the Summit". The Finance Minister understood that the cause of the CCB's March difficulties was the California situation (rather than a weak loan portfolio) and that the deterioration in California had occurred suddenly.

B. REGULATORY RESPONSE TO THE CCB CRISIS OF MARCH 1985

1. CCB Presentations to OIGB and Bank of Canada—14 March

Pursuant to the decisions taken at the CCB Board meeting of 5 March, McLaughlan had explored the options thought to be available (including discussions with the Government of Alberta) and had initiated a portfolio analysis of CCB's Canadian and U.S. divisions. McLaughlan did not seek a directive or authority from the Board to proceed to Ottawa in search of assistance to meets its financial crisis, and none was given.

In Ottawa on 14 March, the CCB President, accompanied by Messrs. Mann and Melnuk, met with Macpherson, Grant, Brossard and Ruxton of the OIGB. The Inspector General was then on vacation and did not have direct involvement in the CCB affair until 20 March. McLaughlan presented a review of the background to CCB's current situation and outlined the responses that had been considered to that point. The idea of a "rescue group" was also introduced. In a memorandum to the Minister of State (Finance) on the same day as the meeting with CCB, Assistant Inspector General Macpherson summarized the initial presentation:

> We were visited today by the Chief Executive Officer of the above bank, Mr. G.W.C. McLaughlan, to be advised of a serious deterioration in the loan portfolio of the bank in recent weeks. The principal reason is the decline in oil prices since year-end which has resulted in the nonviability of a number of the bank's oil-industry related borrowers in the U.S.A.
>
> At the present the bank has classified nearly 30 per cent of its loans as marginal or unsatisfactory. Of that amount, about $257M are nonproductive, yielding no income to the bank. The very recent worsening in the energy portfolio will raise the nonproductive loans to about $350M by the end of April. Apart from the energy loans, the bulk of the weak loans are in Alberta real estate situations. Management has, probably rightly, concluded that the Bank cannot long survive under that burden of nonproductive loans.

Macpherson also briefly described restructuring, merger, and liquidation as three possible approaches for dealing with the situation.

Before returning to Edmonton, the CCB delegation briefed Governor Bouey and other Bank of Canada officials on the CCB's situation and the solutions that had been examined. McLaughlan requested that the Bank of Canada establish a direct line of credit with the CCB despite the existence of existing irrevocable lines of credit with Canadian and U.S. banks. Governor Bouey was left with the impression that there was some urgency in the situation and that the CCB did not have very much time to arrange a solution before a due diligence report to a major U.S. bank and the release of second quarter results.

Evidence relating to an assessment or questioning of CCB's reference to the oil industry situation to explain the bank's change in circumstances is as follows. Vachon did not recall that any question was raised at a Bank of Canada meeting as to why the problems had surfaced at this particular time. There is similarly no indication that the OIGB comprehensively explored McLaughlan's analysis of the deterioration of the energy situation at the time of the 14 March discussions. The office was principally concerned with coordinating the response to the immediate crisis. However, the OIGB did devote some of its efforts to verifying the stated cause of the bank's problems, for the Inspector General received a memorandum on 27 March concerning the performance of the energy sector in which crude oil prices were set out on a quarterly basis for 1980 to first quarter 1985. (See Table D.1.)

Table D.1

Calendar Quarter Price of Saudi Arabian Light Crude Oil

	Q1	*Q2*	*Q3*	*Q4*
		($U.S. per barrel)		
1980	26.00	28.00	29.33	31.33
1981	32.00	32.00	32.00	34.00
1982	34.00	34.00	34.00	34.00
1983	31.00	29.00	29.00	29.00
1984	29.00	29.00	29.00	29.00
1985	28.33			

Allan Taylor, President of the Royal Bank of Canada, consulted certain Royal Bank officials with western oil credit experience to ask about problems with drilling rigs shortly before March 1985. He was informed that the early 1985 situation was "simply a continuation of what we had been witnessing right through '84" and testified that the Royal Bank "had this knowledge of the deteriorating position in the drilling side of the oil business for at least two years ... and had been making provisions for it through that time." From November 1981 to November 1985 Bruce Cockburn was Vice-President of National Accounts, Corporate Global Energy and Minerals for the Royal Bank of Canada. He testified that in early 1985, with the drop in oil prices, the oil rig count in the United States fell to about 1,600 from a high of 4,500 even though there was a belief as late as December 1984 that the process of decline had stabilized and the count would not go below 2,500.

2. Preparations for Bailout — 15 to 22 March

On 15 March, the Assistant Inspector General and Brossard met with the Minister of State (Finance) to brief her on the options then considered to be available to CCB — restructure, merger, and liquidation. Macpherson had already advised the Executive Assistant to the Minister of State (Finance) about the 14 March developments and he had prepared briefing materials for the Minister. Also on 15 March, at the suggestion of Bouey, the Board of CDIC was convened. Those in attendance at the CDIC meeting included Governor Bouey, the Deputy Minister of Finance, Macpherson and Vachon, all of whom were already familiar with the CCB situation. As reported by Macpherson, a range of views was expressed:

> The Governor strongly argued for saving the Bank. The Deputy would be pleased to save the Bank but would not commit government money to a rescue. The Superintendent was concerned about saving the Bank while allowing trust companies at a cost to depositors.

Supporters of assistance for the CCB were concerned that the cost be reasonable.

Allan Taylor, President of the Royal Bank of Canada, who was contacted by telephone on 15 March by the OIGB, indicated the unwillingness of his bank to participate in a "merger" except for the purpose of liquidating CCB. In the light of Taylor's position, the Governor and the Assistant Inspector General concluded that the merger alternative should be dropped.

Bouey and Macpherson decided on 16 March to invite the Chief Executive Officers of the major banks to Ottawa for a meeting in order to determine their views on the impact on the banking system of the closure of the CCB, and to consider their willingness to participate in some form of rescue plan for the CCB. Such a meeting was indeed held but not until 22 March. The Minister of State (Finance) did not wish this meeting to be held at the earlier date because she did not want the knowledge of CCB's trouble to go beyond the Royal Bank until the government had an opportunity to assess the potential solutions further. McLaughlan has testified that Macpherson indicated on Sunday, 17 March that liquidation "seemed to be the alternative that would be selected" because of disadvantages to the other options. In response to this, McLaughlan, with Melnuk's assistance, prepared several alternative recovery strategies, including a proposal similar in outline to the eventual support package, and communicated these to Macpherson by telephone. McLaughlan was called back to Ottawa by the OIGB, and the CCB Board meeting scheduled for 19 March was cancelled.

During this period the OIGB was operating on two tracks; liquidation and some possible means to save CCB.

While arrangements for a support package for the rescue of CCB were being considered, preparation involving the OIGB, legal counsel, and officials from the Department of Finance was under way to implement liquidation procedures if these eventually became necessary. Serious exploration of the technical aspects of the liquidation option was commenced on 17 March and, in that connection, the necessary evidence of the insolvency of the CCB was gathered. A curator was selected and dispatched to Edmonton on 24 March to await further instruction. On the assumption that there would not be agreement on the support package, the Inspector General advised the Minister of Finance in such an event to appoint a curator.

The OIGB then turned to the consideration of a "rescue operation" whereby CCB would continue to function as an independent bank. In essence, this plan was to transfer out of CCB to the six major banks an interest in the poorest loans in the portfolio of the bank, and to replace these loans with moneys to be advanced by the major banks and the CDIC. Such a plan avoided the need to raise new capital for CCB (an enterprise with very doubtful prospects at this time) and at the same time would hold out by share warrants or similar means an opportunity for the participants in the rescue program to realize some return for their efforts and for risking the moneys to be advanced to CCB. This plan was based on McLaughlan's proposal.

On Monday, 18 March, the Assistant Inspector General of Banks brought the Minister of State up-to-date concerning the weekend developments. He "suggested to her the revised support proposal and advised that it seemed the most attractive and likely to succeed". The earliest reaction from one of the larger banks was equivocal. The bank was prepared to assist in any reasonable program eventually agreed upon but it was "somewhat skeptical of the longer-term viability of the bank", partly in light of that bank's experience in the Western market.

The Assistant Inspector General was concerned with the impact the failure of CCB would have on other elements of the Canadian financial system. Small domestic banks "could experience a liquidity crisis and a flight to quality particularly by larger depositors". The failure of CCB "would have severe negative repercussions on smaller financial institutions, particularly those based in Western Canada." Trust companies and credit unions would sustain material losses. There were international implications for Canada and its banking system. The failure of a Schedule A bank could result in disruption of the inter-bank market and "undermine confidence of international depositors and investors." It was also observed that a liquidation of the CCB would be extremely disruptive for the bank's borrowers who were small- to medium-size private businesses, primarily in Western Canada.

In the ensuing discussion, government officials were faced with colliding considerations; a desire to avoid the investment of funds by the Government of Canada in a business enterprise, and yet a serious concern about the disruption of the CCB's borrowers in the event of a failure and the wave effect this would produce in the Western economy. Several other concerns floated to the surface: the importance of maintaining discipline in the economic/financial system, the international implications of the situation, Western financial aspirations and the consequences for the Western Canadian economy, the implications for small banks and other financial institutions, and the viability of the regional bank concept. Mr. M. Cohen, Deputy Minister of Finance, provided the following description of the collective response to the difficult CCB problem involving a series of counter-balancing factors where evidence was neither solid nor complete:

> I think I would describe it by saying to you, on a scale of zero to ten, if zero meant let the bank fail and ten meant save it, some of us were at four and some of us were at six. Nobody was at zero; nobody was at ten. ... By the time it all finished, we had all kind of come to an essential consensus at, what I would qualify, as five and a half to six; that is to say we had all reluctantly agreed that we should save this bank provided the price was acceptable and reasonable. But it was not a polarized affair for any of us.

The Inspector General returned to Ottawa on 20 March. He met during the day with the staff from the OIGB for briefing, with the Governor for discussion of the options and with the Minister of State who asked him to take charge of an interdepartmental working team on CCB. The Minister requested that the group should contain representatives of the Department of Finance, the Bank of Canada, CDIC, the Superintendent of Insurance, senior legal counsel from Finance, a senior communications advisor, and the Chiefs of Staff or their delegates from her office and from the office of the Minister of Finance. The Minister stated: "This group should work to provide the analysis of the situation and present the options available to CCB, the federal and provincial governments. In presenting those options, the costs, impact on the other financial institutions, legal requirements and where possible impact on the economy should be included." At this point the Government had not yet decided to save CCB and had not agreed to commit funds for the purpose.

The Province of Alberta had an obvious interest in the survival of the CCB. The principal investors and borrowers, as well as many depositors, were in Alberta. The head office and most of the bank's employees were there as well. The Province itself was a large depositor. The Deputy Treasurer of Alberta was on hand in Ottawa and was briefed by the Deputy Minister of Finance of Canada.

By the morning of 21 March, the government authorities, including the Minister of State (Finance), were inclined to attempt to save the bank by an arrangement whereby the CCB would sell off an interest in a bloc of nonearning loans to a consortium including the CDIC, the Government of Alberta, and the major chartered banks. The financial involvement of the Federal Government itself was not at that time contemplated. The CDIC Board passed a resolution that day enabling CDIC to participate to the extent of $75M in the proposed purchase of loans subject to four specific provisos:

1. that it be confirmed that the total of the insured deposits held by the bank is approximately $400M;
2. that the estimate of potential losses in the bank's assets as indicated in the report ($244M) are confirmed by the further examination of the bank's loans currently in progress;
3. that the combined contribution of the participating banks and the Province of Alberta be approximately equal to $170M; and
4. that the representatives of the participating banks have expressed their confidence that if the plan is put in place it should be successful in achieving the desired result.

There was otherwise still no commitment of government funds. The Minister of State viewed the willingness of the major banks to participate as a "litmus test" of the apprehended impact of CCB failure on the Canadian financial system, for the banks were better placed than government officials to assess intangible questions concerning confidence in the banking system.

3. Inspections of the CCB

a. First Inspection: Grant and Tallman

On 18 March, Mr. Neville Grant, Director of the Inspection Division of the OIGB left for Edmonton "to monitor and report upon the progress of funding at the Bank, review for reasonableness the financial projections developed by the Bank and begin a review of the nonperforming loans and estimated losses". In Grant's words the purpose of this inspection was "to determine what was the true condition of the bank", to "find out first hand what the situation is". To carry out the inspection, Grant was assisted in Edmonton by Mr. Gordon Tallman, Vice-President, Commercial Banking and National Accounts, of the Royal Bank of Canada. Tallman was made available by the Royal Bank at the request of the OIGB for assistance with the CCB investigation. Mr. James Anderson and Mr. Alister McArthur, also of the Royal Bank, were made available in the same way, to examine CCB loan files in the United States. They reported by telephone to Grant.

The Edmonton inspection dealt with Canadian loans (whether or not they became Support Package loans) for which the CCB had proposed write-offs of $1M or more. Grant stated he expected Tallman to look at the loans as he would do in his own bank and to assess on the basis that the borrower was a "going concern". Tallman has confirmed this general approach and his own understanding that continued operation of the CCB was also assumed. In some cases, Tallman concluded that files should be assessed on a liquidation basis. Where it was evident from the files that a particular client could not be regarded as a going concern, it was necessary to calculate the extent of the expected loss after security had been realized. Grant and Tallman examined 36 loan files falling within the designated parameters for the review in a period of one and a half days. The principal value of the loans examined is not immediately obvious on the evidence. An OIGB memorandum states that the two March reviews covered Canadian loans with a principal value of $900M, and there is a notation that the second of these two reviews covered $602M. Therefore, it would appear that Tallman reviewed loans having a principal value of $300M. The Edmonton inspection was done by Tallman with Grant recording his findings. Tallman examined the credit application, the most recent financial reports, recent asset appraisals where available, and the unsatisfactory loan reports prepared by the CCB. Various CCB officers were also consulted in the course of this review. The bank had identified losses of $141M on the nonperforming Canadian loans reviewed by Grant and Tallman. Their assessment, however, indicated that an additional $67M loss might be anticipated on a "worst scenario" basis. Approximately $48M of this amount was attributable to "significant variances in provisions" on five accounts. To resolve the discrepancies between Tallman's views and the bank's assessment, Grant had determined after lengthy discussions with CCB officials that "the truth is somewhere in between". Accordingly, he reduced the Tallman assessment by about $7M so that the total additional provisions for Canadian loan losses was about $60M. The $60M difference was reported to the OIGB on 21 March.

With respect to the U.S. loans, the Commission has not heard direct testimony. It appears that the Anderson examination corresponding to the Grant-Tallman review involved "100% of the energy loans identified as potential losses and 80% of real estate and commercial nonperforming loans." The Heisz report of February 1985 on CCB's U.S. position (or at least, its overall conclusion regarding estimated losses) was made available to the Anderson-McArthur inspection team in California on 20-21 March. The examination of the U.S. portfolio also resulted in an increased estimate of losses of about $20M (Cdn).

Grant reported the results of the first inspection to the Inspector General, the Assistant Inspector General, and Ruxton on Thursday 21 March 1985. The Inspector General took some comfort from the results as they were "within the broad framework of the bank's own analysis" although he was not provided with details of the review process itself. A memorandum from the Inspector General to the Ministers indicates that Grant's report covered both the Edmonton and California inspections, yet the Inspector General reported an additional $60M of write-offs to the bankers, as will be seen, while the actual results were $80M. Either Grant neglected to report the U.S. results to the office, or some confusion resulted in the report of the Canadian results. Had Tallman's assessment not been changed (and this review was to be an independent assessment), the figure would have been closer to $90M.

The result of the Grant-Tallman-Anderson loan examination was commented on in a memorandum written the morning of 22 March by Mr. W. Mackness, an officer of the Bank of Nova Scotia then serving in the Department of Finance, in which he informed the Minister of Finance that Grant's report from Edmonton "indicates large write-down $300 million versus $244 million". The Inspector General described Grant's first inspection results to the Finance Minister on 24 March as follows:

> On Friday, March 22, 1985 Mr. Grant reported both on his review and that of the banking officials in Los Angeles. Mr. Grant expressed an opinion supporting the views of the Bank that write-downs of $244 million would be necessary and that in the event that the Bank is liquidated, further losses would be experienced. Mr. McLaughlan agreed that the conclusions drawn by Mr. Grant were probable.

The Inspector General must be making reference to Grant's report on 21 March. He failed to point out the wide disparity between the examiner's valuation and that of the bank, even assuming Kennett was not aware of Grant's unilateral reduction of the former's assessment.

b. Bank of Canada Security Assessment of CCB

At the time of McLaughlan's 14 March presentation, Bank of Canada officials had been alerted to the need to supply liquidity support, and thus, to the requirement for an up-to-date security agreement with CCB. This agreement would provide the basis for Bank of Canada financing as it became necessary in the months to come. Governor Bouey has described the normal procedures whereby the Bank of Canada conducts investigations as to the adequacy of the security:

> [T]he starting point is normally an assurance from the Inspector General that the bank is in fact solid, that it has assets that exceed its liabilities. That means we feel that we can lend a substantial portion of the assets of the bank quite safely at that stage. ... Normally we would lend against the most marketable type of securities first: treasury bills, Government of Canada Bonds. Then we might have to go on, if the requirements were likely to be great, to lend against the loan portfolio. The most convenient way of doing that is to take an assignment against the loan portfolio. Then we do feel obliged to do enough work anyway to ensure that the loans do exist on the books of the bank and to find out a bit about them.

Mr. A.C. Lamb, Comptroller and Chief Accountant of the Bank of Canada, was in Edmonton from 18 to 21 March to assess the assets and to arrange the security agreement with CCB. He had previously been involved with CCB in relation to an earlier security agreement in 1983. He was accompanied by Mr. D. Woods (Staff Counsel). Lamb spent much of his time in Edmonton in legal discussions on the details of the security agreement and related questions of opinion letters. In a memorandum to file, Lamb summarized his work as follows:

> The details of the proposed write-down of loans and the general character of the current portfolio were reviewed along with the status of their funding sources. Reports are available regarding their 'overall strategy' and the details of the loans to be written down. The discussions centered on the cause and timing of the problem and on an evaluation of the reasonableness of the proposed amounts to be written down.

Grant was in Edmonton at the same time engaged in the first inspection of the loan portfolio. Lamb of the Bank of Canada and Grant of the OIGB were together on occasion in briefing sessions with CCB officials. Lamb was present on one occasion for an extended period while Grant and Tallman examined part of CCB's loan portfolio and raised detailed questions on the proposed write-downs. He did not discuss the loans and write-downs with Grant in any detail because Lamb's objective in March was to ascertain a general level of security for Bank of Canada advances.

> ... I was anxious to get a general feel for what the write-down was rather than having any particular focus on the portfolio at that stage.
>
> . . .

> What we are trying to do with this facility, ... was to take a very large amount where we could feel secure that we could make fairly substantial advances against it without having to get into detailed evaluation of the portfolio since it is not an area that we would have the people and would have to go out and hire somebody to come in and do that or find some other process of doing it.

In what he describes as "a very first cut and very raw numbers", Lamb concluded, in a memo to file of 23 March:

> The CCB's Canadian dollar General Loans total over $1.2 billion before the proposed write-downs which would enable the Bank to make advances approaching $1 billion with reasonable security.

Lamb did not discuss his conclusion with Grant or the Inspector General.

When, on 3 April, Lamb did have an opportunity to get Grant's impressions on the CCB loan portfolio, he learned of Grant's conclusion based on the first and second inspections that a larger write-down, around $300M, might have been appropriate in the Support Package. Lamb reported his discussion with Grant to Governor Bouey and expressed the view that:

> It is likely that all of these evaluations are conservative since there is little incentive for the individuals involved to underestimate the problem.

Lamb was not aware that the support group banks wanted the Inspector General to confirm the solvency of the CCB, or of the desire of the banks for a comprehensive examination of the CCB loans. When the Bank of Canada subsequently determined that a more detailed examination of the CCB loan portfolio was desirable, the Bank looked to the Hitchman investigation which the OIGB arranged in June: "We would normally have expected to work through the Inspector General; we would not expect to set up a separate or competitive inspection system." This is the extent of the evidence on the linkage between the two principal public agencies concerned with the state of the CCB loan portfolio, although there were also frequent discussions between the Inspector General and the Governor, and ongoing discussions between the two agencies at various levels on other matters related to the CCB.

4. Drafting and Interpretation of the Memorandum of Intent — 22 to 24 March

a. 22 March Meeting

At the invitation of the Governor of the Bank of Canada and of the Government of Canada, the representatives of the six major banks met in Ottawa on 22 March 1985 to discuss the CCB situation. McLaughlan was present for part of the day's discussions, described to the meeting the state of affairs in the CCB, and then withdrew. The Inspector General outlined the alternatives that had been considered and described the support group proposal as previously formulated. The bankers also discussed background considerations and raised a series of concerns regarding the arrangements proposed to them, including the need for the debenture holders to subordinate their interests to those of the Support Package participants, a further examination of the CCB loan portfolio, and Government of Canada participation in the Support Package. The meeting was adjourned on the understanding that if solutions to the questions raised by the bankers' response to the program as proposed by government officials could be found, the parties would reconvene later in the weekend.

Some doubts concerning the communication of information on the extent of CCB's additional loan losses were raised during the course of the Inquiry. The evidence on this issue in relation to the 22 March meeting is as follows.

The Inspector General's speaking notes prepared for the 22 March meeting state:

> The write-offs proposed by the bank are in certain instances not the worst-case situations. To cover such fire sale liquidation values, another $50 million or so of write-offs could be taken. However, our view is that a program providing for a purchase of losses of $244 million will be adequate to secure the viability of the bank.

The Inspector General testified that this was essentially what he told the meeting concerning the Grant and Tallman review. Minutes completed in September 1985 by an official of the Bank of Canada who was present on 22 March indicate that the Inspector General told the meeting "that his own officers had indicated that under the worst-case scenario one might wish to add $60 million to the $244 million in write-offs the CCB wished to make in order to put its affairs on a sustainable basis. Nevertheless, this was in the range of needed write-offs estimated by the CCB, which suggested to him that the Bank's appraisal of the rest of its loan portfolio was not unrealistic." Governor Bouey testified that the Inspector General informed the meeting of an additional $50M to $60M in loan write-offs based on information from Grant. In fact the additional write-offs considered necessary by the professional bankers' inspection team in the L.A. Agency and the Edmonton Head Office were $87M (and reduced by Grant to $80M for no expressed reason other than compromise). This is a 35 to 40 per cent variance from CCB management's estimate.

Fullerton of the CIBC testified and produced notes which indicated that Grant and three Royal Bank inspectors conducted a review, that

Kennett believed $300M was the worst case and that the range was $240M plus or minus $60M. Notes and the evidence of Bélanger of the National Bank of Canada and the testimony of Ritchie of the Bank of Nova Scotia also show that a worst case scenario could involve another $60M above the $244M. Korthals of the Toronto-Dominion Bank stated: "To my recollection, there was not a larger figure (than $245M) in the absolute mentioned, but from time to time there was a conversation at various parts of the table whether another $70M might be required or not". Taylor of the Royal Bank produced notes containing the following: "$244MM – $60MM fluctuates + or –. I.G. says worst scenario $244MM 60 MM – confirmed management estimates ... 244 + (or –?) 60 – Inspector (of I.G.) and RB of C Officers confirm CCB estimates." These notes were discussed with Taylor during cross-examination:

> Q. I take it that your understanding was that that was information that he had obtained from the people who were looking at the loans out west? You understood that that was where it was coming from?
>
> A. Yes, I would believe that to be the case. This is what the Inspector General and his people are saying about this portfolio, with the note, "Confirmed management estimate". Presumably this was in keeping with what the management of the bank had been saying. I think that is consistent with what I have said about Mr. McLaughlan coming in at $244 million.
>
> Q. Yes, and at that figure, the $244 million plus the $60 million, you were content that a package of $255 million would provide solvency?
>
> A. Yes, we were.

It is clear that the seconded bankers working with Grant concluded that a greater write-down of the poor quality portion of the bank's loan portfolio was required than that which had been anticipated by the bank, and that the requirement was more like CCB's worst case estimate. Some of the difference in net value of the loans in the portfolio after such examination between these two different assessments, one by the bank itself and the other by the outside bankers seconded to the OIGB, can be attributed to the different assumptions of the two valuation teams. On some loans, the bank may have contemplated a fairly long workout period (as was their practice) during which the bank would retain the loan assets and realize on the borrower's covenant, or in some instances on the security held by the bank. The bankers working with the OIGB, on the other hand, appeared to take the approach that a present value of the loan was to be determined on the basis that it had been offered to another financial institution, or on the basis that the security had to be realized in an orderly way but over a shorter period of time.

There is some doubt as to precisely what information concerning the Grant and Tallman review reached the 22 March meeting. There is little doubt, however, that some information about this rather hasty valuation of 36 loans by the seconded bankers reached the 22 March meeting in Ottawa, and that those present were advised that the amount required, as revealed by the Grant and Tallman inspection, was in the range of $240M to $300M. It is reasonably clear that for reasons unknown the meeting did not learn of the true variance between the CCB estimate and that of the seconded bankers, however that variance came about.

In response to the program for the rescue of the CCB presented to the meeting by the Inspector General on 22 March, the bankers group, after separate consultation, set out terms and conditions for their participation. In his notes from the 22 March meeting, the Assistant Inspector General recorded the bankers group position as follows:

> Upon reconvening as a whole, the meeting was advised by Mulholland that the bankers had come to a unanimous position:
>
> | | | |
> |---|---|---|
> | Banks' share of support | — | $60 MM |
> | Governments | — | $120 MM |
> | C.D.I.C. | — | $75 MM |
> | | | $255 MM |
>
> No dividends on stock until advance repaid. Half of pre-tax profits to be paid out. No interest or principal payments on debentures. Banks would be in a first-out position. Warrants to represent 75% of stock at $1.00. Interest on performing part of participated assets to go to banks.

The notes of Mr. E. Fine of the Bank of Canada substantially agree with those of the OIGB. He recorded that "the banks expected that another third [$60M] would be provided by the Government of Canada and one-third by the Government of Alberta." With a significance which will later emerge he also recorded: "The interest and the repayment of the pooled assets would go to the banks first." The minutes of Fine refer to the response by the Deputy Minister of Finance:

> ... Mr. Cohen replied to the banks' proposal. He said that it did not appear possible to avoid paying interest on the debentures and to arrange the necessary formalities before the opening of business on Monday morning. Secondly, if the government were to entertain the banks' proposal, it could only be on the basis that all participants rank equally in principle. Thirdly, he said that he had no mandate to offer federal government participation beyond that available through the CDIC. Moreover, he was not sure whether Alberta would be agreeable. In conclusion, he suggested that the meeting should adjourn and that if the Government of Canada could change its view there would be another meeting either Saturday or Sunday.

b. Second Inspection: Grant and the Bankers Team — 24 March

On Friday, 22 March, Taylor and other bankers were anxious for some further assurance that the Support Package as contemplated would be sufficient to assure the viability of the CCB. They hoped on Friday for "a thorough inspection" to provide a satisfactory level of comfort. Nevertheless "the majority of us, and perhaps all of the bankers, had a full realization that there was no way that you could get that done in the two or three days — two days that were available to us". There is no dispute about the bankers' desire for a more comprehensive review. Indeed, Macpherson and Grant immediately arranged for CCB personnel to be present with Grant in Edmonton for an inspection by support group bankers on Saturday, March 23.

Several possible explanations for the bankers' interest in a further inspection appear in the transcripts:

1. lack of awareness of what Grant and Tallman had actually done;
2. desire to assure themselves in the interests of the shareholders they represented that the package would support CCB and that it was not too generous;
3. uncertainty regarding the auditors' results as of 31 October perhaps because of significant changes since then, or because the standards of bank credit officers and auditors differ, or because CCB's serious difficulties arose only four months after the auditors' unqualified certification of the bank's financial statements which reflected no indication of impending insolvency.

The bankers' interest in a comprehensive inspection carried through until at least June when the matter was raised by the senior management of these banks at a dinner meeting with the Minister of Finance. The Banks rejected a suggestion by the Minister of Finance that the CCB auditors do a loan portfolio assessment and expressed their preference that bank credit officers be used instead.

After some confusion surrounding the assembly of the bankers' inspection team was cleared away, the team of bankers began work on CCB files on Sunday morning, 24 March. Seven officials from the major banks worked in Edmonton while two officers carried out the U.S. review in California. The scope of the review was defined by Grant who hoped in one day "to do a review of as much of the bank's loan portfolio or as much of the performing loans as we could". Accordingly, he selected CCB loans of $4M or greater and which were not examined in the first review. The bank made these files available for review. In contrast with the first inspection of Canadian loan files which had been confined to loans on which CCB had already made provisions for losses, the second inspection covered good loans and did not include loans proposed for transfer out of the bank in the Support Package.

As to the nature of the review undertaken, one of the bankers who had been involved in the first inspection stated that the examination on 24 March involved "a different type of assessment". He reviewed six or seven files on 24 March and felt that the time available was satisfactory for him to provide a fair and reasoned assessment. However, another banker who participated in this inspection described the review as "very informal, very quick and hurried":

> I was there for a few hours. There was a truckload of files brought in, and you helped yourself to one off the top, and we would do a quick look at the file and make a quick decision on whether we thought there should be a reserve and how much.

He also described it as a "down and dirty" review. They reviewed 64 of CCB's Canadian loans representing a face value of $602M. The United States review covered about 50 loans, although "different" criteria were applied in the assessment. By this point, approximately 50 per cent of CCB's loan portfolio (measured by outstanding balances) had been examined in the two inspections. In summary, the first inspection team recommended additional reserves of $81M (after Grant's unilateral adjustment), and the second Canadian and U.S. reviews produced recommendations for additional reserves totalling $35M. $27.8M of those reserves were recommended for the Canadian loans examined, and of this amount about $20M was recommended by one examiner who examined "about six loans" of the 64 Canadian loans reviewed.

c. *24 March Meeting and the Memorandum of Intent*

On Sunday, 23 March, the Minister of Finance, the Minister of State (Finance), the Inspector General, Governor Bouey, and the Deputy Minister of Finance met with the Prime Minister. After an extensive review of all the available information, the Prime Minister approved the Government of Canada's participation in the program as an equal partner ($60M each) with the chartered banks and the Government of Alberta, for a total of $180M. A contribution of $75M by the CDIC completed the $255M funding in the program. On this basis, the meeting with the bankers' group was reconvened in Ottawa on

Sunday, 24 March in order to formulate the details of a bailout package. The deadline against which those at the meeting were working was generally understood by all present, as well as by McLaughlan in Edmonton, to be Monday morning, 9 a.m. AST. In the absence of a concluded agreement by this time, the bank would not be in a position to open for business in Halifax on Monday morning. News of the CCB's problems was believed to be "on the street" earlier in the week, and clearly so by Friday morning, 22 March. Since the meeting in Ottawa began about 1 o'clock Sunday afternoon, the participants had only 19 hours in which to complete their task. The OIGB in the meantime had made tentative arrangements for the appointment of a curator in case no rescue program was established for the bank.

The bankers arrived in Ottawa about midday to begin meetings with the Inspector General, Governor Bouey and the Deputy Minister of Finance, together with assorted advisors and lawyers. Counsel, though on hand, were not actually present for the discussion. A draft Memorandum of Intent was prepared by the legal advisors of the bankers' group and subsequently transmitted to CCB. The 24 March deliberations involved the transmission of a series of drafts of the Memorandum of Intent to Edmonton and simultaneous efforts to resolve the status of debenture holders whose position had been described as a "deal breaker" in the negotiations. McLaughlan had returned to Edmonton and was asked by telephone by the OIGB to attempt to work out an arrangement acceptable to the debenture holders which would be consistent with the condition imposed by the bankers. By the afternoon of 24 March, information about the condition of CCB's loans was available from three sources: the management assessment, the first inspection of 20-21 March (Grant, Tallman, Anderson, McArthur), and the second inspection of 24 March (Grant and bankers' group). The speed with which the second inspection group's results were reported on Sunday afternoon was surprising to the bankers and government officials then considering the details of the proposed rescue program.

From the assessment of the weakest portion of the loan portfolio, as well as some loans not theretofore the subject of a loss provision, it is clear that something in excess of $255M had to be written out of the balance sheet value for the loan portfolio. The amount was dependent upon conversion rates used with reference to U.S. dollar loans, the nearness of the delinquent borrower to liquidation, the realization time for security where liquidation must be contemplated, and other such matters. In any case, the consensus of the bankers appeared to have been that the off-loading of $255M in unproductive loans would give the bank a reasonable chance of recovery. A greater transfer of loans of this type might have increased the prospects of recovery of the CCB, but the banks were concerned with their obligation to their own shareholders not to devote their assets in this recovery program to an extent which would unduly reward the shareholders of CCB to the detriment of the shareholders of the major banks. There also was a concern, apparent from the notes of the meeting, about enlargement of the Support Package to the point where its cost would exceed the advantage of the Support Program over an outright liquidation. With certain exceptions, and on the basis of information available to them, the bankers regarded the bailout package as satisfactory to sustain the CCB. The Chief Executive Officer of the Bank of Nova Scotia stated that on the basis of the facts available at the time, CCB had some prospects for survival. The Chief Executive Officer of the CIBC stated:

> We very carefully considered our position and we felt if everything that we had been told, which was an important qualification here, was reasonably accurate, there was a chance that this bank could actually survive over a period of time and that is the basis on which we went in.

Robert Korthals, President of the Toronto-Dominion Bank, on the other hand, had very little optimism for the success of the package because of his view that management changes were required to sustain confidence in CCB in the money market and in the community generally. Mulholland, CEO of the Bank of Montreal, felt that the package would only buy time.

Governor Bouey testified: "I do not suppose everybody was entirely happy with the evidence we had for saving the bank, but we were certainly not happy with the evidence we had for letting the bank fail". Bouey later assessed the adequacy of knowledge available at the time of the Support Package by stating: "... the fact of the matter is that the condition of the CCB was seriously misjudged in the process that led to the establishment of the Support Package". The Minister of State (Finance) commented in testimony to the Inquiry on the same issue as follows:

> In March we felt we had adequate information and we made a decision on that basis. Once again, hindsight tells us we did not have either enough or the right information, but I think in addition there was some deterioration between March and September.

The Inspector General ultimately reached the same conclusion:

> ... we had clearly misunderstood and misstated the condition of the CCB when we went into the bailout. We did not understand, although we tried to understand in the context of timing and we went through that at an earlier session, but we had not understood the extent of the problem there. Consequently, the bailout had failed.

This is a very frank and accurate assessment of the process and its result. By reason of the number of people and organizations involved and the need to obtain authority to act, the process was necessarily slow. The fact is, however, that 10 days passed before the government decided to put public funds into a rescue program. There is no evidence that this was the result of "bargaining brinkmanship". It appeared to be a desire to act only on the basis of adequate evidence or caution. The result was, however, that only 19 hours remained after that decision was made for the design and adoption of a rescue program. This time-bind no doubt contributed to some of the problems which arose. There is no evidence that the result would have been different had a few more days been available to the parties to these meetings from 22 to 24 March. On 25 March, the parties entered into a Memorandum of Intent preliminary to an anticipated final agreement. This was done in order to facilitate the announcement on the morning of the 25th of the Support Program for CCB. In this Memorandum of Intent, the concept was for the participating banks, the Governments of Canada and Alberta, and the CDIC to band together and to purchase a $255M interest in a segment of the loan portfolio of CCB in respect of which the total principal sums outstanding were approximately $530M. CCB retained an interest in this segment of the portfolio amounting to approximately $275M. For its investment in the $255M, the participating bank or government received a participation unit for each dollar invested.

As the moneys were collected from this segment of the loan portfolio, which will be referred to for convenience as the Support Program, those receipts were divided between the participants and CCB as follows: all receipts, whether on account of interest or principal, were to be received and applied by CCB against the CCB participating interest in the Support Program, that is the $275M interest, until that portion was paid off in full; thereafter all further receipts were applied to the retirement of the investment of the participants in the Support Program until the amount advanced by them, that is $255M, was retired in full. In this provision for the distribution of proceeds on receipt, no account was taken of interest as a separate entity. In addition to the application of collections from the Support Program, CCB was required under another provision of the Memorandum of Intent to apply one-half of its income before taxes to the retirement of the moneys advanced by the participants to CCB.

The entire program for the support of CCB was made dependent upon the delivery of a written opinion by the Inspector General of Banks that upon receipt by the CCB of the purchase price for all the participation certificates issued to the participants, CCB would be solvent. The arrangement was also predicated upon the written waiver by all debenture holders of any right to principal or interest until the Support Group had recovered the moneys advanced under the Support Program.

By a final clause in the Memorandum, provision was made for the recovery of any unpaid balance owing to the participants in the event of insolvency by CCB from the estate of the bankrupt. In short, this clause made the advance by the participants to the Support Program a debt of the bank which would rank equally with any like claim by the participating governments remaining unpaid. This clause did not appear in the first draft of the Memorandum of Intent.

Certain provisions in the Memorandum of Intent have been criticized for their possible contribution to the ultimate collapse of the CCB. For this reason, comments on the development and interpretation of the provisions of the Memorandum of Intent are set out below. The procedure leading to the signature of the Memorandum of Intent by CCB and the participants in the program must be borne in mind. McLaughlan left the meeting before the Support Program was discussed, and never returned. When finally settled amongst the participants, it was forwarded to CCB for execution. Many of the points now reviewed were not discussed during the Sunday meeting because the party in interest, CCB, was not present to raise them.

The CCB was critical of certain terms of the draft memorandum including the size of the Support Program. McLaughlan was in Edmonton at the CCB Board meeting where the Support Package was being considered, and he was attempting to resolve the question of the debenture holders' status. He communicated his concerns about the proposed arrangements to the Inspector General in Ottawa:

> The Bank objected to number, pricing and exercise term of warrants and to treatment of amounts collected from weak accounts. Inspector General undertook to re-raise warrants questions with banks but held out little hope of change.

McLaughlan's eventual acceptance on behalf of CCB specified certain conditions regarding tax issues, and other items.

CCB continued to express concern about the impact of some provisions in the Memorandum of Intent as they were later developed in successive drafts of the Participation Agreement. Paine wrote the OIGB on 17 April with regard to the anticipated consequences of the indemnity clause:

> I am writing to you at the request of the Board of Directors of Canadian Commercial Bank. The Board has on 17 April reviewed, among other documents, the latest draft of the Participation Agreement. The concern the

> President has expressed on previous occasions to many of you in connection with the indemnity set out in section 8 of the Participation Agreement is shared by the Board.
>
> In particular, it is felt that section 8 of the Participation Agreement is considerably broader than the provisions of section 12 of the Memorandum of Intent, with the result that the ability of Canadian Commercial Bank to raise deposits necessary to fund its operations may be adversely affected.
>
> The President has explained to the Board that the concerns he has expressed on this point were not shared by members of the Bank Group, but that he was given assurance that if Canadian Commercial Bank's deposit raising activities were adversely affected, the matter would be reconsidered.
>
> The Board appreciates having received this assurance and has taken it into consideration in resolving to approve the Participation Agreement.

Bankers present at the 24 March deliberations have testified as follows:

1. Korthals testified about whether CCB should have been allowed to earn interest on the balance of the loan portfolio that was not being written down: "I do not recall that issue being raised."

2. Fullerton, when asked whether it was brought to his attention on March 24 that CCB wanted changes that would make it possible for the bank to do business after the bailout stated: "No."

3. Mulholland does not remember communications to the bankers about concerns expressed by McLaughlan regarding the terms of the bailout during the 22-24 March discussion.

4. Ritchie on tightening the terms and the warrants in particular stated:

    > I certainly did not have a feeling that the conditions that the banks were laying on the table to make this deal work varied that much from the original terms. I think, as you get into the drafting of the agreement, this has to be translated, obviously, into language that leaves no doubt in anyone's mind as to what the intent was.
    >
    > Insofar as the warrants were concerned, I guess that is a straight question of what the evaluation of those warrants were. Insofar as providing the income on the assets that the CCB were holding, I did not hear the complaint from Mr. McLaughlan that this was a problem.

    On the question of allocation of proceeds from the support group loans, Ritchie stated:

    > I believe as we moved along either Friday or as we moved on the weekend, certainly we in essence were buying the nonperforming or the write-down of that portfolio. It was always my understanding that CCB would have the first crack at the proceeds of those loans. I think this was outlined also

later on in the sense that we bought a package, but things were individually identified as to the portion that the CCB would carry. And the proceeds from pay-down of those individual loans were reapplied first to eliminate or liquidate the CCB portion of the principal, and the residual then be applied on the support groups' package.

5. Bélanger of the National Bank made notes of the 22 March discussion which contain references to particular terms of the bailout agreement. He commented on the evolution of those terms over the weekend:

> Q. I see. If I can ask you to turn to page 25, please. The second last point at the bottom of the page says:
>
> > — all interest on 245MM of assets to banks and all proceeds from assets until paid out.
>
> Can you explain to me, sir, what that term means?
>
> A. What term?
>
> Q. The term I just read. All interest on $245 million.
>
> A. It means that if we are buying $245 million worth of bad loans, any income on these loans should be to us.

Several explanations or interpretations of the Memorandum of Intent were subsequently prepared for the advice of the Minister of Finance and the Minister of State (Finance). A memorandum from the Inspector General to the Ministers dated 24 March explained the repayment arrangements as follows:

> CCB will repay the Support Group the full amount advanced in the following manner:
>
> a) Any payments on any loan in the portfolio will first be applied to the outstanding balance of the particular loan on the books of CCB. Any additional amounts will be paid to Canada, Alberta and the Bank Group in proportion to their participation in the agreement until they are repaid in full. Any further amounts will be paid to CDIC, which is thus placed in a "last-out" position.
>
> b) Regardless of what payments are received in respect of each loan, CCB must make quarterly instalments to the Support Group equal to 50 per cent of CCB's pre-tax income. These payments will be applied to the outstanding balance of the advance. The governments of Canada and Alberta and the Bank group will be paid in full first with subsequent payments being made to CDIC until it has also been repaid in full.
>
> There will be no payments of interest on the funds advanced.

The Minister of Finance requested further detail on the treatment of weak loans which would be participated out by CCB to the support group. On 27 March the Assistant Inspector General replied as follows:

> The procedure will be as follows:
>
> 1) The Bank will identify a portfolio of weak loans with a carrying or book value of approximately $544 million.
> 2) The Support Group will pay $255 million for their participation in those loans. The $255 million is the equivalent of the amount required to write down the loans to realizable value.
> 3) Upon completion of the transaction, the Bank will receive $255 million in cash and reduce the carrying value of its loan portfolio. There will be no other changes to the balance sheet of the Bank. The total assets do not change. The Bank continues to carry the residual value of $289 million ($544 - 255) on its books.
> 4) The Bank will continue to manage the accounts attempting to realize on them. Any repayments in excess of $289 million will be paid to the Support Group. C.D.I.C. will not receive any such payments until the others in the Support Group have been fully paid.
> 5) The Bank will pay 50% of its annual pre-tax profits to the Support Group. These payments will be applied to the $255 million.
> 6) The participation certificates are purchased on a nonrecourse basis.

The note does not mention the disposition of any interest received.

The Deputy Minister of Finance forwarded to the Minister of State a summary of the Memorandum of Intent containing this explanation of the allocation of proceeds from the support group loans:

> The restructuring plan enables CCB to remove the provisions for loan losses from its balance sheet. The Memorandum of Intent provides for a large package of loans with different allocations going to the different members of the Support Group. This is intended to ensure that there are cash flows available to both CCB and the Support Group.
>
> *Allocation of Proceeds from Loan Portfolio*
>
> The loan portfolio is structured such that CCB's portion should yield sufficient revenues to allow it to write down its participation in the portfolio. (In effect, the agreement provides CCB with the loans most likely to perform profitably.) However, should conditions improve beyond expectations, and the revenues from CCB's portion of the portfolio exceed the bank's participation, the excess would first be allocated to the non-CDIC members of the Support Group. After the other members of the Support Group have been reimbursed, additional revenues from CCB's portion of the portfolio will be allocated to the Canada Deposit Insurance Corporation (CDIC).

In testimony, the Assistant Inspector General provided a succinct explanation of the evolution of this aspect of the Support Package, and the nature of its ultimate impact on CCB:

> I think it is essential to bear in mind that when the Support Package was conceived CCB indeed was saying we have this portfolio of weak accounts and we want to transform this volume of nonperforming or marginally performing loans into fully performing loans. And we will do that by selling to the

> participant groups the loss portion of those loans. The remainder of the CCB portion would then be fully performing, that is they were written down to the level where it was expected that the remaining *tranche* of that package of loans would produce some income.
>
> It was that expectation and that conception that enabled CCB to prepare projections of its future operations to indicate that the bank indeed would be profitable from an early point following the putting in place of the support arrangement.
>
> The way that this section of the support agreement actually came out, however, meant that the CCB portion of the support assets would from that point forward be nonperforming forever or at least until such time as the full principal amount of those loans was recovered. That is CCB would never, in compliance with the terms of the agreement, be able to recognize any income from the CCB portion of the portfolio assets.

On 26 April 1985, as the Participation Agreement was nearing completion, the Inspector General set out his understanding of the ranking of creditors in the case of insolvency. CCB had expressed some concerns about the impact of this provision on its capacity to raise and retain deposits:

> Section 8 and Section 13 deal with the ranking of creditors in the case of the insolvency of the CCB. Under the Agreement that I expect to be closed on 29 April, the Support Group, except for C.D.I.C., will be ranked *pari passu* with depositors in a liquidation. The Bank is concerned that this may impair its ability to raise deposits. They believe that the Support Group should be ranked after the depositors. The banking group have disagreed and have insisted on the existing ranking. There is an understanding, however, that if evidence emerges that this arrangement is hindering the funding of the Bank, then the ranking will be reconsidered by the participants in the Support Group. In these circumstances, I personally believe that it will be necessary to alter the agreement as the Bank has suggested.

5. Debenture Holders, Press Release, and CCB Assistance Act

a. Debenture Holders

Korthals explained the bankers' group view of the significance of the debenture holders' position to the Inquiry:

> Debentures are part of a bank's capital in theory and they are subordinated to the other claimants, and it bothered us that we were coming in on a rescue package behind the debenture holders. I mean it was just structurally a wrong thing to do and it really would also, if that was the way that future rescues — heaven forbid that they would have to happen were — then the debenture holders really cannot be viewed — or debenture capital is really not capital for a bank. So we thought it was very important that the debenture holders come in behind the bank rescue package as being part of the capital of the bank.

Thus the position of the debenture holders remained a significant concern late on 24 March as the bankers' group continued to insist on the principle of subordination. The Inspector General had phoned McLaughlan on 23 March to advise him that there was a deal and requested him to use CCB's "best efforts" to get the agreement of the debenture holders to postpone. Through McLaughlan's efforts, a meeting with debenture holders had been arranged for 25 March in Edmonton, but this would not be in time for the decision needed. Governor Bouey and the Deputy Minister of Finance began to contact debenture holders directly on the evening of 24 March to explain the circumstances of the proposed bailout, and to seek the agreement of debenture holders to waive interest and principal payments. The debenture holders' rejection of this proposal led ultimately to a decision by the Governments of Canada, Alberta, and British Columbia to purchase at par $39M in outstanding debentures in order to permit the Support Package agreement to proceed.

b. The Press Release — 25 March

On 25 March, the Department of Finance issued a press release, "Support Package to Ensure Viability of Canadian Commercial Bank", to provide information on the arrangements that had been worked out. It was also an acknowledged purpose of the press release to inspire some measure of confidence in the public who depend on the banking system that the bailout package would be effective.

> The Honourable Barbara McDougall, Minister of State (Finance), announced today that a joint agreement has been reached to ensure the long term viability of the Canadian Commercial Bank. Parties to the agreement, which involves an infusion of capital with repayment provisions, include the Province of Alberta, six Canadian chartered banks, Canada Deposit Insurance Corporation and the Government of Canada.
>
> The Support Package is designed to provide the Canadian Commercial Bank with sufficient funds to ensure solvency following a recent and sharp deterioration in its U.S. loan portfolio.
>
> The agreement will result in the purchase by the support group of a package of nonperforming loans. This transaction will leave the bank in a strong position of solvency in order to support its deposit base.
>
> Representatives of the Canadian Commercial Bank notified the Office of the Inspector General of Banks on March 14, 1985, that the deterioration in its loan portfolio could place the bank in a position whereby it could be unable to meet its obligations to depositors and creditors.

> Following analysis of the Canadian Commercial Bank's position, the Inspector General of Banks determined that an infusion of additional funds in the amount of $255 million would ensure that the bank could continue to play a key role in the western Canadian economy.
>
> A restructuring package initiated by the Canadian Commercial Bank was negotiated by the Inspector General of Banks with the parties to the agreement.
>
> The CDIC, which is funded by member deposit-taking institutions, will provide $75 million. The remaining $180 million will be shared equally by the Province of Alberta, the banking group and the Government of Canada in the amount of $60 million each.
>
> The repayment program calls for the Canadian Commercial Bank to pay 50 per cent of its future pre-tax profits to the participating institutions until the capital is repaid in full. The remaining 50 per cent will be retained by the bank. No common or preferred share dividends will be paid until the repayment program is complete. As part of the transaction, members of the support group will be entitled to receive warrants and payment of principal and interest on subordinated debt will be postponed.
>
> In a separate arrangement, the governments of Alberta, British Columbia, and Canada will be purchasing up to $39 million of the subordinated debt.
>
> 'I have full confidence that this cooperative Support Package involving Canada's largest chartered banks and the two Governments will permit the Canadian Commercial Bank to continue its active and important role in the growing economy of Western Canada', said Minister of State (Finance) Barbara McDougall. 'I have in addition been assured by Governor Gerald Bouey that as usual the Bank of Canada stands ready to provide liquidity for Canadian Commercial Bank, if requested, as well as for any other Canadian bank.'
>
> The Minister concluded, 'This Support Package represents a strong collective vote of confidence in the health of the economy of Western Canada.'

The Minister of Finance, the Minister of State (Finance), the Inspector General, and the Governor of the Bank of Canada stated in evidence that the press release fairly reflects their conclusions and convictions at the time of the agreement. Bélanger commented on the press release by stating that he had no reason to doubt the strong position taken on the solvency of CCB but had some doubts about the expression of its ensured long term viability. With reference to the latter he concluded: "I would not argue that it was wrong, I think it may not have been prudent."

c. CCB Assistance Act

On 29 March, Bill C-37, the *Canadian Commercial Bank Assistance Act*, was passed. This legislation authorized the Minister of State (Finance) to make agreements as necessary in order to provide financial support to the CCB according to the terms of the Memorandum of Intent. In addition, the act authorized payment as required from the Consolidated Revenue Fund of $75M for the financial assistance of CCB.

C. PREPARATION FOR THE PARTICIPATION AGREEMENT

1. Bank of Canada Advances

On 29 March, Governor Bouey explained the process leading to the Support Package to members of the Board of Directors of the Bank of Canada and advised that very large advances to the CCB might be required in the weeks to come. The board minutes state:

> In the event that large scale support was required and appeared to be necessary for a considerable time, the Governor said that the Board might be called upon to approve the setting up of a reserve. This would involve delaying the transfer of Bank of Canada profits to the Receiver General.

Bank of Canada advances (Table D.2) increased rapidly through March and early April. The news media interpreted these figures as showing that the bailout was not a success. In an attempt to bolster confidence in CCB, the Bank of Canada, on 18 April, issued the following press statement:

> ... however, with the agreement of the Canadian Commercial Bank, the Governor, Mr. Gerald K. Bouey, confirmed that the Bank of Canada has been providing liquidity support to that chartered bank. The Governor noted that it is the role of the central bank to act as an ultimate source of liquidity for Canadian banks, and he reiterated that the Bank of Canada stands ready to provide the Canadian Commercial Bank with whatever amount of liquidity support it may require.

Bank of Canada advances to this point amounted to $649.9M. Governor Bouey reported to the Board of Directors of the Bank of Canada on May 3 that although this press release had been intended to confirm the liquidity support being made available by the Bank of Canada it "had been interpreted in some quarters as a 'second bailout' and had not helped the situation as much as hoped." The Governor then told the Board that "the struggle to establish the CCB's longer term viability was likely to be a protracted one."

Table D.2

Profile of Bank of Canada Advances to the CCB and Northland Bank—March-September 1985

1985		*Northland*	*CCB*
		($ millions)	
March	27		15.0
	28		118.0
April	3		336.8
	10		470.3
	16	35.0	615.5
	17	35.0	649.9
	24	51.0	728.1
May	1	94.0	645.3[a]
	8	74.0	721.8
	15	64.0	748.9
	22	109.0	833.5
	29	111.0	875.0
June	5	167.0	936.8
	12	254.0	969.0
	19	343.0	1,034.5
	26	323.0	1,072.6
July	3	372.0	1,149.3
	10	347.0	1,211.5
	17	369.0	1,267.5
	24	417.0	1,254.5
	31	378.0	1,225.2
Aug.	7	452.0	1,288.0
	14	472.0	1,309.5
	21	510.0	1,299.6
	28	510.0	1,310.1
Sept.	4	510.0	1,316.0
	11	510.0	1,316.0
	18	515.5	1,272.3
	25	517.5	1,272.2

[a] Net of repayment of $255 million provided by the Support Group on 30 April 1985

The Bank of Canada liquidity advances (Table D.2) which were contemplated by all parties present on 24 March, would, by virtue of the Bank of Canada's security agreement with CCB, have priority over the $255M advanced by the members of the support group. The result of all these procedures is somewhat anomalous. The debenture holders who were not depositors were paid out in full prior to the rescue operation's commencement. The banks who became unsecured creditors to finance the rescue operation have no priority over the Bank of Canada. And finally, the banks are ultimately not classed as depositors and therefore do not qualify for reimbursement under deposit insurance or under the extended compensation pursuant to the special Act enacted in April 1985. In the end, all the participants in the rescue lost their advances to the Support Program, although the debenture holders (whose debentures ranked as part of the capital of the bank according to the OIGB rules) were paid off in full.

2. The Inspector General's Solvency Letter—26 April

As a condition of their participation in the bailout, the support group banks sought a firm written assurance from the Inspector General that upon receipt of $255M the CCB would be solvent. Under cross-examination as to whether the support group banks expected the Inspector General to provide an assurance, a warranty, a certificate of solvency, or an opinion based on good judgment, Allan Taylor replied:

> I expected to get his opinion as to the solvency of the bank, given all the information that he had. But his opinion as the regulator of banks in Canada and with his responsibilities, we, the banking group, put a great deal of weight on that opinion.

On 26 April 1985, pursuant to para. 14 of the Participation Agreement, the Inspector General provided the letter required, stating: "In my opinion, Canadian Commercial Bank will, immediately upon receipt by it of $255,000,000 pursuant to the terms of the aforesaid Participation Agreement, be solvent." This opinion was not based on a comprehensive audit of the CCB's loan portfolio, but it was thought to be supported by the last audited financial statements, the new capital, and the March loan review of over 50 per cent of CCB's loan portfolio conducted by experienced credit personnel from Canada's major banks. In reality the $255M was applied to reduce the liability but itself became a repayable obligation.

3. The 29 April Participation Agreement and Related Documents

During the weeks following the completion of the Memorandum of Intent, the parties worked on a more comprehensive document intended to formalize and clarify the basic terms agreed to in late March. On 29 April, after the Parliament of Canada had enacted the *Canadian Commercial Bank Financial Assistance Act* authorizing the Government of Canada to enter into the Support Program, the parties executed a Participation Agreement. This agreement is in replacement of the Memorandum of Intent, and only those provisions which are novel or which are a variation of the provisions of the preceding Memorandum of Intent need be examined.

CCB warranted under the agreement that the portion of each loan retained by it in the Support Program represents the bank's best estimate of "the amount likely to be recovered from or with respect to that portfolio asset". When this total reserve interest by CCB is subtracted from the principal outstanding under all loans in the Support Program, the remaining amount is the participants' interest in the Support Package, namely $255M. In these provisions setting forth these calculations and representations, no mention was made of interest accrued, accumulating or otherwise, and the recovery of moneys from the borrowers in respect of these Support Package loans, was again subjected to an allocation program that made no distinction between a payment of interest and a payment of principal.

Nothing appears in the record to indicate that any further discussions were held on this subject. As to the terms of the Memorandum of Intent on this point, it is clear from the testimony of those present at the 24 March deliberations that CCB was truly in a position of having to take the proposal as worked out in the meeting or there would be no agreement for a Support Package at all. Consequently, the bankers present did not consider that they were in a negotiating meeting, but rather in a meeting to lay down the ground rules for the establishment and for the operation of the Support Program. McLaughlan maintained throughout the process, and indeed throughout the hearings, that one of the factors which brought about the failure of the Support Package was the inability of the bank to realize any income during the Support Program from the loans made subject to that program, and that this had a serious and, in his view, fatal effect on the prospects of the bank achieving a recovery. Without being able to report earnings, CCB could not attract deposits, and certainly could not attract new capital. The Agreement is even more explicit than the Memorandum in delineating CCB's obligation to deliver over to the participants those proceeds received from the borrowers in the Support Package loans, together with one-half of CCB's before-tax income, until the participants have received "an amount equal to the price paid by such participant for its participation certificate."

Again, the Participation Agreement, like the Memorandum, established the right of the participants in the Support Program, other than the CDIC, to rank *pari passu* with the right of the depositors of the CCB to payment in full of their advances under the Support Program. This right of recovery by the participants survives any insolvency of CCB. It is to be noted that Schedule 1 attached to the Participation Agreement makes no reference to accrued interest or capitalized interest but rather deals only with principal outstanding under each loan at 31 March 1985. This outstanding principal sum is then apportioned between the "syndicated portion" (the participants' interest) and the "CCB portion."

The Agreement makes provision for the designation by the Inspector General of two persons to act as his representatives in supervising the administration of this agreement "and the portfolio assets by CCB".

D. IMPLEMENTATION, OPERATION, AND MONITORING OF SUPPORT ARRANGEMENTS

1. Decision to Undertake Further Portfolio Review

Mr. Bruce Cockburn of the Royal Bank of Canada and Mr. J.R. Johnston of the Toronto-Dominion Bank were named as special representatives of the Inspector General pursuant to section 7 of the 29 April Participation Agreement. Section 7 defined the relationship of the representatives to other participants as follows: "The Special Representatives will report to the Inspector General, who will keep the participants fully informed." Sometime around 14 May, this "third inspection" team began work at the CCB. Cockburn and Johnston did not conduct a full review of CCB loans; instead they concentrated on support group loans until their appointment was terminated in June. Not until after they had left did a review of other loans get underway.

The terms and scope of the special representatives' appointment aroused some controversy in the hearings because of criticism of the length of time required for the OIGB to mount a full assessment of the CCB portfolio and because of Allan Taylor's assertion that the need for such a review was understood by the support group bankers in the meetings in March. The Memorandum of Intent contains no reference to a comprehensive review of CCB. Taylor's evidence on the issue of a review of nonsupport group loans is that as of Sunday, 24 March:

> We all believed that we had made the point sufficiently clear that there was to be a full inspection of this bank to be done by banking officers provided by the six banks. The agreement called for these two special representatives, and we believed that they would have played a part in this expanded review of the total bank.

Taylor assumed that the inspection ("a full examination of that bank's portfolio and the balance of the bank, the other assets of the bank") was a condition of the basic bailout arrangement and should have been in the agreement: "It was a complete oversight right through the piece in not getting it in writing". Taylor clarified this comment by stating:

> I meant that in hindsight, we all realized that it was an oversight not to put that into the agreement. I did not mean to leave anybody with the idea that we all had understood and it was agreed it would be in the agreement. That was not the case. But in hindsight we certainly did come to appreciate the fact that that was a very strong missing element from the agreement itself. It should have been a written condition of the deal.

Taylor says he often referred to the inspection in discussions with the OIGB but did not push the matter because of all the effort going into the participation agreement. Taylor had not expected the assessment to precede the flow of funds although he had expected that steps towards a full inspection would commence as soon as possible after 25 March.

Bélanger was not willing to say that a "further complete audit" was discussed in March, but he described the weekend inspection (the second inspection) as a "stop gap measure" and stated: "It was very important that all concerned would go to the bottom of this as soon as they could. If you left it in those words, I would say yes, this was discussed *ad nauseum* one way or the other".

Fullerton expected that "after the original rescue package went into place, the officers designated by the chartered banks to assist the Inspector General would go in and would examine the remainder of the portfolio that had not been examined". He indicated that the results would not have been available to the CIBC: "We had never had any right to go into that bank and never would". Rather, the results would have been available to the OIGB and "might have triggered additional action".

Mulholland testified that he did not complain about the absence of a full audit and indicated that although the Inspector General gave an undertaking to appoint some monitors, he did not give a detailed undertaking as to what they would do. Mulholland told the Inquiry that the supervisors "were urged repeatedly to conduct a complete inspection of the entire loan portfolio from 'A to izzard'," but "there was a generally sort of fuzzy response until the clock ran out. ... It did not get exactly an adamant refusal but it did not get a clear acquiescence either". Ritchie has no recollection of a specific discussion establishing that there would be a continuing audit of the CCB portfolio outside the

Support Package. Korthals stated: "I am a little hazy as I left the meeting on what my perception would have been, but I had the feeling, in looking back, that we had agreed that groups of officers from other banks would do more examination of the bank's loan portfolio. I think a lot of that was set up later." He also confirmed the view he expressed to the Blenkarn Committee that the further inspection was actually done "fairly quickly".

Taylor stated that the use of the special representatives to conduct the review of loans outside the Support Package was discussed in April. On 10 April 1985, following the regular semi-annual meeting between Governor Bouey and six bank CEOs, which had been scheduled six months earlier, there was some discussion of the CCB situation. Minutes state: "In any event, it was agreed that the two bank officers who would be stationed at the CCB for the purposes of the Inspector General would, in addition to their other duties, be used to improve knowledge about the quality of the loan portfolio". However, Bouey firmly restricted the scope of the examination intended by the reference in the minutes: "I would not regard that as anything like a comprehensive audit".

In mid-April, the bankers were looking for four more names to suggest as inspectors in addition to the two special representatives, but it was assumed there was no need to produce those names to the OIGB until the Participation Agreement was in place. The terms of reference for the inspectors could not be established before the Agreement was signed by all parties so it was not possible to put people from other banks in place. The names of bankers available for work at the CCB were not forwarded to the OIGB until sometime between 29 April and 3 May.

The actual terms of reference or instructions for the special representatives prepared by the OIGB in May appear to leave open the possibility that they might become involved in an inspection of nonsupport group loans. Those terms of reference state: "Because the Inspector General wishes to have continuing and up-to-date knowledge of the bank's portfolio, the Inspector General may ask the representatives to broaden the scope of their evaluation of loans beyond the portfolio assets." However, at a meeting involving Grant and senior officials from CCB it was agreed that the special representatives would not be requested to review CCB loan accounts outside the Support Package. If such a review were desired the Inspector General would engage noncompetitor representatives.

Allan Taylor indicated that on several occasions between 29 March and 14 June, he complained to both Ministers about delay in initiating the inspection. The Minister of State had no recollection of Taylor raising the further audit issue until about 20 May, and she stated: "I never had any sense of pressure or urgency about it if he did raise it earlier". Following the 20 May talk with Taylor, the Minister of State spoke with the Finance Minister about the audit as part of a broader look at CCB but she recalled no specific criticism by the Finance Minister at that time of OIGB failure to mount a full inspection. The Inspector General confirmed that the need for a loan review or full audit was raised from time to time by the bankers, but not pressed until June, and definitely not promised. No one ever suggested it be put in the Participation Agreement.

It has been argued that even if there really was no agreement with the banks in March, April, or May for a full review of CCB loans (whatever the banks understood that to be), nevertheless, some form of review of nonsupport group loans was by then long overdue, and ought to have been launched by the OIGB as prudent regulatory behaviour without pressure from the banks. The Inspector General stated in response to this suggestion that it did not appear necessary or prudent to launch a fuller inspection immediately after the March weekend because "we were preoccupied with other things" and because the appointment of special representatives would have provided a means to review all the loans "in an orderly way": "We certainly did not feel that that was a matter of desperate urgency". It also appears that the Inspector General actually considered that a full audit in April would have been damaging to public confidence and the success of the bailout:

> The public perception certainly would have been at least confused if, following the strong assurances that they were given, we would then be seen to be mounting a substantial audit or loan review in that bank.

The Inspector General suspected that the existence of a loan review with the help of active or retired bankers could not have been kept from the knowledge of the financial community.

2. Third Inspection: The Special Representatives

The Inspector General wrote Allan Taylor of the Royal Bank 3 May 1985 stating:

> At your request, in connection with the closing of the transaction contemplated by the Participation Agreement, I confirm that the Special Representatives will take an active role in relation to any material dealing by CCB or any person on its behalf with any Portfolio Assets.

As finally drafted in May 1985, the "Terms of Reference" provided in part that:

> The main responsibilities of the representatives are generally to supervise:
>
> 1) the administration of the Portfolio Assets of Canadian Commercial Bank (CCB), as defined in the agreement.
> 2) the administration of the Participation Agreement.

On 22 May 1985, Johnston, Manager of Toronto-Dominion Edmonton Commercial Branch, and Cockburn, a Vice-President of the Royal Bank of Canada then stationed in Calgary, were appointed by the Inspector General as Special Representatives pursuant to Paragraph 7 of the Participation Agreement. They actually began to function on 14 May.

Cockburn understood that representatives of the other support group banks were available if a decision was taken to proceed with a full-blown inspection. Johnston also understood that any review of loans outside the support group was to be left for further discussion. The Inspector General confirmed that the possibility was left open in correspondence that Cockburn and Johnston would carry on with a full review of CCB's portfolio. Macpherson testified to his assumption that at the outset Cockburn and Johnston were expected to be at CCB three or four months, and that they would eventually look at all the files. However, the review of nonsupport group assets was not undertaken as part of the Cockburn and Johnston effort.

At Grant's suggestion, Cockburn assumed responsibility for the U.S. side of the operation because of his energy-related background and because energy loans were considered a significant element of CCB's problem in the United States. Cockburn examined about 80 support group loan files from CCB U.S. platforms in San Francisco, Denver, Century City (Los Angeles), and Santa Ana. MARGUN reports for April were not adequately filled out but the May reports were complete, and continuing improvements in the quality of the reports were anticipated. Cockburn concluded that the U.S. staff, which was "very, very co-operative" and "very knowledgeable", had performed "very well" in liquidating the loans, especially in real estate, and that several other improvements were underway in the U.S. operations. Of the 72 May MARGUN reports on support group loans examined by Cockburn, only 10 of the loans were made after 1983.

Cockburn understood that his primary task was to monitor, not manage, the realization of the support group portfolio because it was originally felt there would be some recovery for support group participants. He did not view a further assessment of the adequacy of the provisions for loan losses as a formal responsibility under the terms of reference: "As I went through each individual file I noted for my information certain situations that looked like it sic could develop into further appropriations, but that was for my own information". Further:

> It was only after I came back from Santa Ana (24 May) when there was some suggestion about, you know, could there be further appropriations, that I went back in my files and prepared this list for Mr. Grant.

When he did so he reported to Grant that additional provisions totalling $7.25M (U.S.) were required on a conservative basis for thirteen of the support group loans in the United States. This information was given to Grant in Edmonton on 20-21 June when Cockburn also provided Grant with information on interest capitalization which he expected Grant to take up with the external auditors.

Grant also met with CCB's auditors on 20-21 June for discussions about the bank and provided Robert Lord of Clarkson, Gordon with details of the additional provisions required on the "Portfolio Assets" in the Support Package. Grant requested a report from the auditors on interest capitalization during the second quarter, 1985. The auditors had not, of course, performed an audit on this fiscal period but were able to report as follows:

> In our discussions with management, we raised the comments made by the special representatives of the Inspector General of Banks relating to the apparent capitalization of interest into certain of the loan balances included in the participation agreement. Management gave the following explanations ...
>
> 1. In the case of U.S. loans which were classified as earning loans prior to being included in the Support Package, interest was capitalized up to 28 February, 1985.
> 2. In the case of Canadian loans classified as earning and included in the Support Package, interest was capitalized up to 31 March, 1985.
> 3. No interest was taken into income on nonearning loans included in the Support Package. However, in the case of a few nonearning loans, interest which had previously been included in income and not capitalized for legal reasons was capitalized into the loan balance as of the date of the support arrangement. The most significant of these was [borrower name deleted] where the accrued interest capitalized into the loan balance in March, 1985 had been taken into income in 1983. Accrued interest on nonearning loans not previously taken into income was not capitalized into any loan balance.
>
> We have not carried out any audit procedures to verify the foregoing, the explanation would appear to be reasonable based on reported net loss for the second quarter.

This is but further evidence of the widespread practice in the bank of capitalizing interest on problem loans.

Johnston examined Canadian support group loans and reported to Grant periodically through June. Johnston treated the CCB as a going concern for purposes of his assessment of the support group loans: "My instructions — the approach to the bank was to preserve it and ensure that it remained a going concern, and I did not go in on the liquidation scenario." On 7 June, Johnston provided the first of his series of reports. He had by this time reviewed 58 support group loans and as "a provisional total only" recommended additional appropriations totalling $46M (over and above the $255M). Johnston emphasized his position by stating to the Inspector General:

> It is the writer's considered opinion that if CCB is to proceed expeditiously to liquidate its portion of the portfolio assets then additional provisions are necessary, failing which any degree of timeliness can largely be discarded.

Upon completion of his initial review of the smaller loans making up the remainder of the Canadian support group loans, Johnston concluded, in a report to the Inspector General dated 24 June, that overall "a grand total of $50,000,000 in round figures" should be added to the loss provisions. In light of new information made available at the 21 June meeting with CCB officials, Johnston thought that a further $20M (over and above the $50M) might be required. Johnston testified that the $20M figure for further provisions was arrived at "in my own mind". There is no indication that this assessment of the further $20M was relayed to the OIGB although Johnston did express to Grant some reservation that the $50M might be low. Johnston, as a monitor, had no authority to insist on further specific provisions. His views were, however, discussed at a meeting of Grant, Johnston, and senior credit officers of CCB. Grant participated in the negotiations, and the end result was that CCB agreed to book further provisions of $33M, being comprised of $14M in the third quarter of 1985 and $19M at year end. There is no evidence that any of this was reported to the support group participants by the OIGB.

In addition to his views on additional provisions, Johnston presented a series of criticisms of CCB management procedures and practices:

> In the main, the injuries suffered by CCB would appear to be self-inflicted in many instances with most lending decisions having been fee-driven even on 100% in-house financed restructures. The drive for business was well recognized in the field with account officers on a profit-sharing/bonus system at one time, tied to loan quotas. [There is no evidence on the record to support this statement and the liquidator issued a press release stating there was no evidence suggesting the existence of such a bonus system.]

> The Platform discretionary limits may have been (still are) too high and it was rare to see a Corporate "Decline" followed by approval on reworking. In other words Approvals were given with apparent scant regard for detailed examination of an application.
>
> Ongoing capitalization of interest is a major concern and has been detailed for you in the attached reports. It is unconscionable inflation of the balance sheet which is graphically illustrated in so-called workouts where land values, which appear in a Loan Realization Account, are manipulated upwards to fit, or suggestedly rationalize, the new credit approval.
>
> You will see that, in several instances, CCB actually has a recent appraisal or valuation but chooses to ignore it and opts for value based on "future potential", "replacement cost" or "take-back financing" etc. and thereby nullify the need for an appropriation. Indeed, as late as March 31, 1985, Platforms were rationalizing, in a plausible and unchallenged manner, the lack of need for appropriation and then substantial usage was made of the trough provided by the Support Group. It is very difficult to reconcile the two approaches.
>
> There was almost a venture capital air to certain situations where CCB stipulated a share in cost profits/sales proceeds or the acquisition of, or option for, shares in private companies.
>
> According to the information provided by CCB, the timely presentation of applicable Credits to the Board is somewhat of a 'hit and miss' situation and detail in that respect will be found in the attached 'Comment on Boarding'. The significance of Boarding is recognized and is treated as an inviolable requirement in the writer's recent environment. The 'Comment on Boarding' speaks for itself, and upon raising the obvious question the answer was that Directors are polled by telephone. One might feel that such deliberations would be formalized, in written form, as soon as possible thereafter but a culling of the files by CCB staff still produced only the results as attached. For Board Sheets, only the 1984 and 1985 files were searched.

It should be noted that on cross-examination, a number of practices or conditions within the bank were admitted by Johnston to be unsupported by evidence, supported by weak evidence, or possibly common within the banking industry but not within Johnston's own range of experience. In one specific case, the criticism regarding boarding practices, other witnesses were able to verify that, in fact, the loans had been boarded. Paine testified that Johnston's comments in relation to the "venture capital air" at CCB appeared to be the comments of somebody at the middle management level as opposed to the senior management level.

By late June, Cockburn felt that the continuing task of monitoring the support group loans could be accomplished in two days a month. He proposed to Grant that inspection of the remainder of the CCB portfolio should get underway so that the Bank of Canada, which was funding the exercise, would know what was there. Johnston also concluded his basic assessment of the Canadian Support Package loans in four or five weeks and was prepared to work outside the support group package on the remainder of the CCB portfolio. Johnston urged a fuller review on 7 June:

> Given the displayed state of affairs in the Portfolio Assets it is clearly indicated that, by your leave, an examination of other classified loans should take place in due course.

The Inspector General stated that he had originally expected the special representatives to be retired bankers, and was surprised when active bankers were made available. Notes of the March meetings indicate that "retired bankers" were specifically mentioned for the watchdog role in the Support Program. The Inspector General further stated that the OIGB would have kept Cockburn and Johnston on to do the full portfolio review and to help with Northland, except that both CCB and Northland objected. The Inspector General said that CCB "complained vigorously about having active and competitive bankers looking at its live portfolio" and that McLaughlan was "most unhappy". McLaughlan's testimony is more ambiguous in that he acknowledged expressing concern about live bankers and confirmed a preference for retired bankers but said it was "no big deal", "I certainly was not making anything substantial about it". Taylor suggested that declarations of secrecy should have resolved any concern that may have existed.

3. Fourth Inspection: Hitchman

In her efforts to find some new directors for CCB who would assist in some respects with representation of the taxpayers' interest, the Minister of State met on 22 May with George Hitchman, a retired Deputy Chairman of the Board of the Bank of Nova Scotia. Hitchman demurred, stating that he would need to know more about the asset side of the bank before deciding whether he had a contribution to make to the Board. He offered to look at the assets and report back. Hitchman contacted Paine, expecting that he would speak with Mr. R.A. Utting, Vice-Chairman of the Royal Bank of Canada, and would call him back. Utting had recently agreed to examine CCB's procedures and management on behalf of the bank. A few days later when Hitchman had not heard again from Paine, he left a phone message at the office of the Minister of State declining the board position.

The Finance Minister met with the heads of the six major banks in Toronto on 13 or 14 June to discuss several topics including the CCB and its net worth. They indicated their concerns about several factors "in a pretty forceful way". The Minister clearly understood "that they felt that it was very important that we come to grips with a clear understanding at an early date of the degree of solvency of the bank".

Taylor testified that he discussed the need for a fuller inspection of the loan portfolio with the Inspector General at a Canadian Bankers' Association meeting on 13 June and again on the following day with the Minister of Finance. On 19 June, the Minister of Finance and the Inspector General met. The Inspector General had begun to replace the two active bankers, Cockburn and Johnston, with two retired bankers, Farthing and Taylor. The Minister of Finance wanted Hitchman added to the review team, and asked for the loan examination process to be speeded up. The Minister significantly expressed concern for the security of funds being advanced to CCB by the Bank of Canada and asked that:

> ... the Inspector General ... put together a team, perhaps under the leadership of Mr. George Hitchman, to carry out a complete appraisal of the value of all of the assets of the Bank to confirm its net worth position. Such a team would have to have confidence of the banks in the support group.

The interrelationship of the Bank of Canada and the Office of the Inspector General in this whole process is illustrated by a memo prepared in the Bank of Canada:

> Mr. Kennett had requested the meeting to discuss a proposal for a detailed evaluation of the CCB's total loan portfolio. He reported that at a meeting with the Minister of Finance the previous day the Minister sought reassurance that the CCB was indeed solvent. Mr. Wilson had dinner with the six major banks a week ago and some banks suggested that it was unlikely that the CCB still had a net worth. Mr. Kennett had outlined the steps that had been taken to date but the Minister suggested that in view of the billion dollars in advances outstanding to the bank he was anxious to have an early and complete assessment of the bank's net worth. The Minister had noted that in earlier discussions with the Governor it was clear that the Bank of Canada relied on the Inspector of General of Banks to provide assurance of a bank's solvency.
>
> He [Kennett] noted that the Bank of Canada clearly had an interest in the valuation of the loan portfolio and he sought our support for the evaluation and wondered if we would be willing to underwrite a portion of the costs.
>
> Mr. Crow indicated that while we certainly had an interest in the study, it was important that the study be undertaken under the responsibility and direction of the Inspector General of Banks. The "jointness" of the Bank of Canada's involvement came from the fact that it would be very interested in the results of an evaluation of the CCB portfolio and would be pleased to provide assistance in the study and/or in funding part of the costs. Mr. Kennett said that suited him and that he would welcome our participation at whatever stage seemed to us appropriate and that the results would of course be provided to us.

In the result, Hitchman, Taylor, and Farthing were appointed by the Inspector General to review all the loan portfolio, other than the support group loans which had already been examined. According to their terms of reference these consultants were to act as agents for the OIGB for the fourth inspection of CCB. They were requested to "review credit files, accounting records and such other data as necessary to form an opinion on the quality of the loan portfolio and the adequacy of provision for losses". In addition, the Hitchman team was to review the CCB's credit authorization practices and control procedures applicable to unsatisfactory accounts, as well as the bank's then current practices on fee income and interest recognition.

Hitchman commenced his study on 2 July, and concluded as early as 15 July that there was "real cause for concern". He met with McLaughlan and Grant of the OIGB on 23 July for discussions of individual loan files which the team had reviewed. On 30 July, Hitchman provided to the Minister of State, in response to her request for prompt results, an oral interim report (accompanied by a package of completed loan reports) based on 34 loan accounts reviewed by Farthing and Taylor. Hitchman agreed to the Minister's request to proceed quickly toward a final report. The OIGB recorded the discussion at this meeting with Hitchman: "On the basis of extrapolation of their findings, it was their view that CCB should take write downs of as much as $500 million on their loan assets. Final report expected in mid-August '85". On 1 August, an adviser with extensive banking experience who was serving temporarily with the Department of Finance concluded from the Hitchman interim report that there was "an equity deficiency that will amount to several hundred million dollars", that "the bank has a very large negative net worth", and that "it is clear that the CCB is insolvent".

While the Minister of State did not see the Hitchman review as part of a merger option, she was interested in exploring the possibility of a merger of CCB with another bank.

4. Relationship of the Hitchman Group and Other CCB Investigations

There has been some criticism of the CCB inspection process mounted by the OIGB because of a suggested lack of communication or coordination between the four inspection teams and between the inspection teams and the auditors. Hitchman testified that he did not know and did not work with others who were examining CCB:

> Our assignment was to review the assets of that bank in accordance with the Terms of Reference. So, I was not frankly interested in anybody else's review.

Unfortunately, the OIGB did not coordinate or connect the various examinations, standardize their procedures, or define the standards to be applied in loan valuation with any degree of precision. Nor did it acquaint each team with the work of the other special examiners. In fairness to the OIGB, the terms of reference given to Hitchman included: "The agents may consult as required with the Auditors of the Bank and the former special representatives of the Inspector General." Hitchman did not look at the minutes of the Audit Committee of the Board of Directors of the bank and did not receive any correspondence or memoranda from the auditors to the Audit Committee regarding the 1983 or 1984 financial statements. He did meet with the auditors in Edmonton on 22 July in order "to discuss the procedures which the auditors used in their loan review". In any case, it had been made clear to the Inspector General, by the time the Hitchman team was appointed, that the bankers wanted bank credit officers and not the bank's auditors to examine the CCB loan portfolio. In a memorandum to the Minister of Finance of 26 June, the Assistant Inspector General stated: "Utting and Hitchman will consult one another to coordinate their separate efforts". This was not arranged as Kennett apparently felt that Utting would deal adequately with the business plan while Hitchman valued assets and credit procedures.

The extended audit provisions in the *Bank Act* were not utilized in March or April in connection with the support group arrangements and the Participation Agreement. The OIGB's reasons for not involving the auditors have already been reviewed and in the circumstances, the Ministers did not consider it appropriate to exercise powers under the *Bank Act* to extend the CCB audit. Following the Participation Agreement, the Inspector General did discuss quarterly statements and matters relating to the audit with the bank's auditors, but this was in the course of regular contacts with the bank and was not connected with the implementation and operation of the Support Program. The auditors were not engaged by the Inspector General to examine the CCB loan portfolio.

5. Utting Investigation and Report

Utting, a very experienced banker, was engaged by the Board of Directors of CCB by letter dated 16 May 1985:

> ... to enquire into and report upon the Bank's broad concepts and practices including but not limited to its controls, procedures, communications, credit granting, restructuring and workout of loans with full access to all personnel and areas of the Bank.

In addition, Paine had an unwritten understanding with Utting that he would provide the Board with an assessment of management. The OIGB shared this understanding that Utting would review the strength of CCB management and so advised the Minister of State on 31 May. The Inspector General described the Utting review as "a very positive step" and indicated that news of the appointment had been favourably received by a few of the CEOs of the major banks. Utting's notes state that although the judgments taken by management on workouts were reasonably supportable "and may not have been significantly different than judgments taken by many banks in North America, they were in fact high risk judgments requiring in most cases that virtually all subsequent developments be on the favourable side".

His review of the quality of management follows:

1. Generally good.
2. C.E.O. provides strong leadership. He recognizes need for added support and strength.
3. Communication — Very Good.
4. Remarkable dedication on part of middle and senior management.
5. Several pockets of good skills and competence within senior and middle management.
6. Planning processes presently underway rate out very well.
7. Credit policies and processes currently employed also rate out very well.

(Relative to #6 and 7 these people are saying all the right things. The real test will be in implementation.)

(The assessment in #6 and 7 may very well appear in contradiction of what will come out of the I.G.'s examination i.e. Hitchman report.)

8. There has been considerable turnover in the past 2/3 years but most middle and senior management posts are filled by experienced bankers and while there may be a shortage of outstanding star performers there do not appear to be areas of glaring weakness.
9. Financial Management is well supported by outside professional advisers and all aspects of problems are being addressed aggressively.
10. Overall a favourable impression is formed but the proof will only be assessable when results permit more precise approval of performance. There are many inherent or latent problems and targets set for the cleaning house as well as moving forward clearly contain an element of optimism and perhaps some over-optimism but this and the other is probably an essential ingredient if the very remarkable spirit and attitude of the management team is to be sustained.
11. Notwithstanding the favourable tone of the foregoing the public perception of management still continues to be a cross the Bank will have to bear until credibility and confidence can be restored.

6. Report of the Standing Committee on Finance, Trade and Economic Affairs

On 18 April, the Standing Committee on Finance, Trade and Economic Affairs was instructed to consider the circumstances leading up to the Support Program. On 3 June 1985 the Committee completed its review respecting circumstances relating to the Support Package offered to the Canadian Commercial Bank, and on 12 June it reported to the House of Commons. The Committee reported on the background and evolution of the CCB including the Westland's acquisition. It also examined credit and accounting practices within the bank. The Committee's assessment of the origins of the CCB's difficulty in the spring of 1985 was as follows:

> [T]he history of CCB has been marked by a series of imprudent lending policies, questionable accounting practices, inadequate information disclosure and lack of supervisory enforcement. It is the contention of the Committee that the present problems of the Bank are a consequence of its aggressive and imprudent lending policy dating back to the late 1970s. The difficult economic conditions in recent years only exacerbated the fallacies of that lending policy resulting in an ever greater temptation to use accounting techniques and selective information disclosure to show good financial performance.

In conclusion, the Committee indicated that its assessment of CCB's management capability "is clearly at variance with that of the Inspector General of Banks." The Committee reported that as of 7 May, the Inspector General had advised that the present management of CCB was "sound", and expressed his confidence in the bank's management. The Committee concluded its report by stating:

> [I]mplicit in the acceptance of the Inspector General's assessment is that management was fully aware of the implications of its decisions and actions. Events have shown that management accepted risks beyond the realm of prudence. The question then becomes whether supervision in this instance was adequate. In the final analysis, questionable accounting practices, inadequate disclosure and lack of supervision do not by themselves cause bank failures. Bad management and lack of credit practices do. Management alone carries the responsibility for all its decisions.

The CCB prepared an extensive response to this report. McLaughlan testified that it undermined the confidence which at the time CCB badly needed to survive:

> Well, again its very negative tone certainly undermined again confidence in the investment community. In terms of the bank ... it was very negative and, in my opinion, very misleading and based on several serious errors.
>
> Maybe just one point worth mentioning to the Commissioner. We have no idea where this ever started but it was the first time we had seen evidence of it. One of the serious criticisms and one that was widely published of this House of Commons Finance Committee Report was that this bank had paid its loan officers a commission to make loans. I recall one of the committee members spending a lot of time on Canada AM talking about, well, what would you expect from a bank that has its employees paid commissions to make loans. They are like life insurance salesmen running around selling policies.

> Well, that particular criticism, I have no idea to this day where they ever came up with that particular conclusion. But it was very damaging, that amongst several others.

After the bank went into liquidation, the curator issued a press release stating that he and his staff had found no evidence whatsoever of loan officers ever having been paid a commission for making loans. All of the bank officers as well as long-time directors deny that the practice existed.

7. Relations of the Support Group Bankers with CCB

Canada's major banks were not only involved with the CCB as participants in the Support Program, they were in contact with CCB in the ordinary day-to-day operations of the banking system. Suggestions have been made that following the Support Program, several of the major banks sought to reduce their exposure to the CCB, and that their actions reflected a lack of confidence in the CCB which increased CCB's difficulties and contributed to its continuing deterioration and the eventual failure of the attempted rescue. The maintenance of existing credit relations between the CCB and the support group bankers was not discussed, let alone clarified, during the meetings of 22-24 March, 1986. The issues were not raised by the bankers themselves who would have been familiar with at least their own situation, by the Bank of Canada which had general knowledge of the matter, or by the OIGB which had no specific knowledge of the interbank credit but which in its ordinary inspection duties was aware of such arrangements in a general way. Governor Bouey assumed in March that after agreement on the Support Package, relations between the banks and CCB should return to "normal".

Immediately following the press release on 25 March, the CCB learned that certain existing lines of credit with other banks would not be renewed. The Toronto-Dominion Bank, for example, indicated that a $10M line of credit described as a Canadian Last Resort facility, which had expired 28 February, would not be renewed. It also capped an existing inter-branch guarantee at its current level. The CCB was advised in March that the Bank of Nova Scotia intended to cancel a $10M credit facility. Bank of Canada records also indicate that these lines of credit, and others with a number of Canadian and foreign banks, had been cancelled or were otherwise exhausted. McLaughlan stated that the cancellations had a two-fold effect. First, they increased the amount of borrowing the CCB required from the Bank of Canada to deal with liquidity problems, and second, the cancellation of interbank facilities made it difficult for a number of CCB's customers to operate their normal current accounts. The OIGB was concerned with the potential problem that would result if word got around that the major Canadian banks in the support group were no longer dealing with the CCB. The impact of this problem would be difficult to assess. On 10 April, Governor Bouey met with representatives of the six largest banks to discuss the Support Package. Notes of that meeting state:

> At the outset, the Governor expressed concern that banks, by showing in some instances unwillingness to deal normally with the CCB were threatening the confidence that the support group package had been designed to bolster.

In late May, with the knowledge and support of the Minister of Finance, Governor Bouey personally took action to assure normal relations by writing to each of the six major chartered banks.

Several possible explanations of the banks' failure to renew lines of credit with CCB as they came due emerged during the Inquiry. First, although the support group's participation was arranged on an agreed basis among the banks, the existing deposits/lines of credit had not been so arranged, and the risk might be considered inequitable. Second, the debenture holders had already been paid off in full but the bank participants in the support group did not have depositor status, and therefore were not led to expect compensation for losses as would be provided to both insured and uninsured depositors. Perhaps this exposure to loss, which the bankers did not consider to be fair treatment, was a further reason for the unwillingness of the major banks to extend their exposure to loss beyond that specified in the Support Program itself. Third, the lack of a full review of the CCB loan portfolio outside the Support Package left uncertainty regarding possible losses still unprovisioned. Finally, for security purposes Bank of Canada advances ranked ahead of normal deposits in the event of an insolvency. Thus, the increased liquidity advances from the Bank of Canada had the potential to undermine the prospects of recovery for other depositors, and certainly reduced the prospect of recovery for any losses incurred by the major banks in their participation in the Support Program. Accordingly, the banks may have believed it reasonable to have the Bank of Canada attend to any advances required by CCB beyond those specified in the Support Package.

Evidence before the Inquiry also indicates that representatives of support group banks actually regarded the withdrawal of interbank deposits as part of "normal" relations. This is so because interbank deposits are liquidity placements and because they are unconfirmed and unadvised; there is no obligation to renew the investment. Allan Taylor told the Inquiry: "I think it is very important to know that normal relations for the trader would be to discontinue placing funds with this bank on March 25. That would be normal relations. It would be abnormal to be carrying on, especially under the circumstances that we saw, continued drawing from the Bank of Canada, no restoration of confidence in evidence." In any event, Governor Bouey concluded that since CCB's problems were on the asset side rather than the liability side, the withdrawals "had no effect on the ultimate outcome". Macpherson testified that McLaughlan never complained that the withdrawals wrecked the bailout. The Inspector General stated that the run-off of deposits was "a relatively small factor".

8. Reassessments of CCB's Condition

a. August Meetings with CCB Representatives

The Inspector General and the Minister of State met with the CCB Chairman in Toronto on 9 August after the conclusions of Utting's review of CCB's management had become available to CCB and while Hitchman was preparing his final submission. The Inspector General in a memorandum of 15 August described the essence of the meeting.

> At that meeting, Mr. Paine explained that with the anticipated losses and write-offs, the Bank would be out of capital by year end. He reported that in Mr. Utting's view, management was competent and was doing what they could in the circumstances. However, the Alberta commercial real estate market was a disaster and this had to be taken into account in further write-offs.

The Minister of State testified:

> The bank itself then approached us on August 9 and said they felt at that point they had until the end of the year and suggested that more government support might be a good idea.

A further meeting occurred on 13 August of the Chairman and officers of the bank, the Governor and Senior Deputy Governor of the Bank of Canada, the Inspector General and the Assistant Inspector General of Banks. In preparation for this discussion, McLaughlan prepared a memorandum in which he stated:

> It is now clear that unless CCB obtains additional financial assistance, the Bank will be technically insolvent (no capital) at fiscal year-end 1985. Since the implementation of the March 1985 assistance program, an additional $200 million of loan losses have been identified (based on a worst case scenario) and the level and carrying costs of nonearning loans have increased.

McLaughlan reported that the objectives of the Support Program were not being achieved because CCB was unable to liquidate its nonperforming loans even at their written down levels. One-third of CCB assets were nonearning or partially earning. The Alberta real estate market was still in difficulty, and because of the obligation to repay the support group portion of the loans under the agreement, the bank was unable to recognize income on loans that it retained. At the meeting on 13 August, McLaughlan estimated that the costs of liquidation, including the costs of the liquidator, would amount to $750M together with the CDIC losses which were expected to reach $269M, including $75M of insured deposits. Therefore he concluded that, after the retirement of the prior claim of the Bank of Canada for liquidity advances, any other depositors in the bank would receive 25 cents on the dollar.

The notes of the 13 August meeting prepared by the Senior Deputy Governor of the Bank of Canada state in part:

> The initial presentation by McLaughlan centered on the fact that the objectives underlying the Support Package were not being realized. The Support Package was based on the view that the value of the $530 million in the Support Package when disposed of in the market would prove to be some 53 per cent of the book value. However, the amounts being realized were in the range of 30-35 per cent. If this was extrapolated through the whole $530 million, the deterioration against what had been forecast came to about $100 million. In addition, there was a running loss as a result of the lack of income-producing assets to the Bank. Looking forward, it appeared that the Bank's capital would be eliminated by the close of the fiscal year.

b. The Merger Option

The option of merger as a means to avert collapse of the CCB had been set aside in March at the time of the decision to implement the Support Package proposals. However, further consideration was given to the merger option during July and August although the view generally held by that time was that CCB was in a worse state than appreciated in the period of 14 to 25 March 1985. McLaughlan was not involved in any merger discussions between 25 March and 13 August. McLaughlan was advised by the Inspector General on 13 August that an interested merger candidate existed and that if other possibilities appeared, they would also be examined. McLaughlan then met with the potential merger candidate in Edmonton and outlined the portfolio as well as the potential losses on liquidation. Nothing came of this discussion. The Inspector General reported on the amalgamation option (in the case of both CCB and Northland) to the Minister of State on 23 August. The memorandum reads in part:

> No bank would be willing to amalgamate with them unless some third party (i.e., the CDIC or the government in some form or other) pays the larger bank. Payment could be by purchasing bad and nonearning loans at face value or by funding the nonearning loans and providing an indemnity against losses.

He added that the costs of such a payoff would have to be borne by the Government of Canada one way or another. He concluded: "Obviously, there is little to distinguish this from a liquidation approach. ..."

In late August, the Finance Minister was advised by another potential merger candidate, "Unfortunately there is just no point in us going ahead here. You have got a dead bank on your hands."

c. *Opinions on Solvency*

Opinions as to the solvency of the CCB evolved in response to continuing developments during the summer of 1985.

On 3 June, the Inspector General advised the major banks that all Canadian banks are solvent and deserve continued extension of normal banking relationship. About one week later, on 12 June, the Inspector General reported CCB's second quarter results — $21.7M net loss — to the Minister. Although these results were not encouraging, because of special circumstances they were also not a basis for forecasting and the Inspector General stated that he was "confident that the Bank is on the right track".

At approximately the same time (21-22 June) Grant, Johnston, Cockburn, and CCB personnel concluded that a $50M additional write-down was needed on the the support group loans. This was additional to the $255M provision assigned under the Support Package to the major banks. As already seen CCB was by now reporting deficiencies on realizations from disposal of security held in the Support Package loans. The Inspector General reported CCB difficulties to Mackness of the Department of Finance who in turn reported a "high risk" situation to Wilson. The Inspector General stated that the phrase "high risk" is not his, and further: "At this stage I had no reason to believe that it was insolvent. It was still operating on a considerable capital cushion". Yet the Inspector General says: "Our concern began to mount" from the time of the $50M write-down recommended by Johnston and Cockburn on Support Program loans, but he still believed the CCB was solvent.

On 10 July, during a tour of Western Canada, the Inspector General met with Mann, Smith, Gaudet, and Melnuk of CCB and subsequently with representatives of the auditors. The Inspector General's notes from these meetings are as follows:

> *July 10 — Edmonton*
>
> Canadian Commercial Bank — Mann, Smith, Gaudet, Melnuk — Al Taylor supportive of rescission of amalgamation with REIT unitholders — expects trouble selling it to other banks — wants 2-3 weeks — rescission may impair capital and require Order in Council — now expecting possible capital reduction of 50-65 million — every effort to reduce assets, sell written down loans — reducing overheads ... US has prohibited any upstream funding by Commercial Centre Bank — CCB agency —

CCB auditors

> — auditors reviewed 6 month figures — expect to be called in for 3rd quarter — in regular contact with Bank and helping in planning — Lord negative about return to profitability without further help re funding costs, debenture, etc. — pessimistic — very unhappy about parliamentary committee report and that whole experience. ...

As of 1 August, when he received the interim Hitchman report, the Inspector General explained: "I was satisfied still, on the basis of the bank's own figures, which was all I had, that the bank was solvent. I was not rushing to the view at this precise moment that the bank was insolvent. ... We were anxious to have every opportunity to view this situation and to review it thoroughly and to make sure that we had all the evidence in and could move with conviction before we moved".

The 9 August meeting with Paine and the Minister of State in Toronto, and the follow-up session on 13 August, were significant turning points in the OIGB's overall assessment. The Inspector General said that McLaughlan indicated CCB "would be insolvent" and stated "we were still collecting all the evidence", but he conceded that the bank was "pretty well" insolvent at this date. Nonetheless, the Inspector General wrote on 20 August: "My advice that the bank should carry on its deposit business as usual was based on the very thorough analysis by the Bank indicating that at this point in time it continues to be solvent. In that circumstance and having in mind the active search for an ultimate solution to the Bank's problems, it seemed unnecessary to me to limit deposits at that time." This letter was a follow-up to a phone call between the Inspector General and Paine in relation to the latter's letter of 13 August seeking confirmation of the Inspector General's view that CCB could continue to accept deposits over $60,000. The Inspector General explained the dilemma facing the bank supervisor in these circumstances:

> I was not in a position where I could advise the bank that it should take this action, that it should be partly opened in some sense, and that it should be behaving in a way that would put whatever additional risk there was in this situation entirely on the Canada Deposit Insurance Corporation. The bank should either be open and operating or should be closed, and obviously we were not ready at that particular point in time to close the bank.

McLaughlan did not admit that CCB was actually insolvent on 13 August when he met with public officials. The thrust of his presentation was that CCB was going to have its capital wiped out in the coming three to four months: "So it was headed for insolvency".

The Minister of State (Finance) had an adviser's memo of 1 August which stated: "On the basis of Hitchman's preliminary analysis and conversations with Mr. McLaughlan, it is clear that the CCB is insolvent, probably, to the tune of several hundred million dollars". The Minister of State was also present for part of the 13 August meeting when Paine and McLaughlan presented their conclusions, and she concluded at that point that the CCB was insolvent. The final Hitchman information and the collapse of the merger option confirmed to the Minister that liquidation was the only option. She says the same decision would have been reached without the Hitchman findings.

Mackness' conclusion of insolvency following the 30 July interim Hitchman report has already been discussed. Almost one month earlier Mackness had reported to the Finance Minister that the Inspector General's "greatest concern is that the basic situation is continuing to deteriorate vis-à-vis asset valuation and nonperforming loans". Mackness concluded at that time that the $255M write-down from March should be $40-$50M higher and he advised the Minister of Finance that "There is a sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now".

The Minister of Finance also indicated that the numbers presented at the 13 August meeting pointed to the conclusion that CCB was then insolvent. He also addressed the issue of whether CCB should have been taking uninsured deposits:

> Well, that is where you get to a very difficult area when a bank is in a very delicate position between solvency and insolvency.
>
> Up until then we had gone for over 60 years without a bank failure. There is I think a very strong tradition of a solid Canadian banking system, so that we wanted to make sure before we took action on this that there was further work that would be done by other people in order to confirm what Mr. Hitchman had said.

Minutes of the 18 June Board of Directors meeting of the Bank of Canada where the Governor set out his views on CCB read in part:

> In a more detailed briefing on the Alberta banks, the Governor said that, as expected, confidence in the CCB had remained weak, and had not been helped by the publicity surrounding the Report by the House of Commons Committee on Finance, Trade and Economic Affairs and the publication by that bank of a large, albeit expected, second quarter loss. ... The Bank of Canada had remained in close touch with the CCB and with its plans to improve its situation.
>
> He noted that the Inspector General of Banks continued to take the view that the CCB and the Northland were solvent and it was clear that a pick-up in the Alberta economy would help the situation of both banks. He added that it was likely that advances to these banks would continue to remain large for some time to come. Both the Alberta banks were attempting to broaden their retail base, but this took time.

Bouey received the preliminary Hitchman report, "a bunch of loose pages", about 6 August, and was in attendance at the 13 August meeting. In the hearing he said, in reference to his views at the time of the 13 August meeting: "I would say the bank was certainly headed for insolvency, that it was not insolvent at that moment in terms of net worth, but that is where it was headed". Although the Governor felt it was then possible for the Bank of Canada, without the advice of the Inspector General, to decide that the CCB was not viable and to cease lending, this was not done in order to allow further exploration of the merger option and consideration of what to do about the uninsured depositors. The Bank of Canada continued to make advances to the CCB on the basis of its stated commitment to maintain liquidity funding to any bank considered by the OIGB to be solvent.

9. Hitchman's Final Report

The final report of the group under Hitchman's direction appointed to examine the loan portfolio of the CCB was completed on 12 August 1985. The Hitchman Report was based on a review of 84 individual loans representing total CCB loans with an outstanding balance of $423,219,000. Hitchman reviewed no loans in the Support Package. It should be noted that the Support Package involved the write-down of some $255M on loans the outstanding balance of which amounted to $540M. These loans, plus those examined by Hitchman, amounted to approximately 40 per cent of the total portfolio. The report, together with appendices reporting on individual loans, was delivered to the Minister of State on or about 13 August 1985.

In a summary of his findings, Hitchman's 12 August report stated:

> *Summary*
>
> A. A substantial provision for losses on loans is required — whether it be $910,026,000 or $1,063,278,000 or some reasonable percentage of such figures. To this must be added operating losses for 1985 of some amount — not yet available until statement is audited.
>
> B. When and how the outside auditors will give a "clear audit" for the October 31, 1985 statement, with the information now available — is also an unknown at this date.
>
> C. The Bank is heavily indebted to and surviving on assistance from the Bank of Canada. As at June 30 the amount was $1,082,320,000 and the Bank had:

Demand deposits of	$ 194,841,000
Payable after Notice	5,866,000
Payable on fixed date	1,214,807,000
Total	$1,415,514,000

> and has no predictable Cash Flow coming in from assets.

D. Time is of the essence to reach a decision on the future of the Bank.

The Hitchman Report presented several types of financial analysis of the condition of the CCB loan portfolio which were summarized as follows:

9. *Marginal/Unsatisfactory Loan Summary as prepared by C.C. Bank as at May 31, 1985*

Summary

Total Bank Loans — $2,363,705,000

Marginal/Unsatisfactory		
Canada	$531,405,000	
U.S. Division	191,491,000	$722,896,000 — or 30.5% of total loans
of which —		
Non Earning Loans		
Canada	$291,569,000	
U.S. Division	166,678,000	$458,247,000 — or 19.31% of total loans

These figures are AFTER TRANSFERRING $255,000,000 loans to the Support Group.

10. *Summary of Review of Loans made by the Hitchman Team*

Number of Accounts reviewed — 84 out of almost 550; that is 15%.

Total Amount of Accounts reviewed — $423,219,000 out of $2,363,705,000; that is 18%.

We rated accounts and established a provision for losses as follows:

Classification	No.	Amount	Provision for Losses	Provision as % of Amount
Good	23	$ 48,907,000	$ —	—
Weak	12	51,639,000	400,000	.8%
Doubtful	49	322,673,000	162,378,000	50.0%
Totals	84	$423,219,000	$162,778,000	38.5%

A critique of Hitchman's methodology identified several limitations in the exercise. The 84 loans selected were not statistically representative of the overall CCB portfolio and the sample may have been too small to provide an adequate reflection of the portfolio. Also, as the sample was weighted in favour of large dollar and higher risk loans in Alberta and the Maritimes, extrapolation may not properly reflect the loan condition of the overall portfolio.

The final Hitchman Report set out the following general comments:

> 13. *General Comments Based on our Review of C.C. Bank Loans*
>
> (1) Some loans were initially made on 100% of cost of real estate; T.V. Cable franchises; and other assets. Borrower had NO equity in asset.
>
> . . .
>
> (5) Moving problem or bad loans for substantial sums to a new name and then calling the loan current, is not a proper procedure to follow.
>
> (6) Re-writing loans and capitalizing past due interest and provision for future interest is just not acceptable.
>
> (7) Adding substantial fees to loans where collectability is in doubt, or re-writing loans and then taking such fees into profits, creates a false and improper short term profit picture.

The Hitchman Report also noted that bank management stated that "all energy is being devoted to collection — little or no marketing is being done", and concluded that this should mean a reduction in assets. The accounts of the bank revealed however that the loan portfolio increased $68M between 31 October 1984 and 30 June 1985. McLaughlan's evidence on this final point was that the CCB REIT merger increased the bank's loan portfolio by $47M while foreign exchange movement on the U.S. dollar assets added $35M to the asset totals. McLaughlan equated this $82M total with Hitchman's $68M figure to show an actual decline of $14M of bank loan assets during the period.

It should be noted that the criticisms contained in the Hitchman Report were vigorously attacked. The following is illustrative of the attacks mounted on the Hitchman Report by management and others during the Inquiry. Most criticisms regarding CCB procedures and documentation were subsequently shown to be without foundation. Hitchman admitted in cross-examination that the bank did not move bad loans to new names, so as to show them as good loans and disguise such moves. Hitchman's loan reviewers, Messrs. Taylor and Farthing, did not review branch files, and admitted that in some cases they lacked information, in which case they took a more pessimistic view of the loan. Taylor expressed his concern to Hitchman that he would prefer to visit the branches; however time constraints rendered this impossible, and given the choice to quit or stay on using Head Office files only, Taylor chose the latter. The Head Office files are often not nearly as detailed as the branch files. The reviewers did not meet the borrowers or view the security. Hitchman's sample and the method of extrapolation rendered the final dollar figures for reserves unreliable. He reported that the bank often engaged in 100 per cent financing, a bad practice, while other bankers testified as to the difficulty of avoiding this on workouts. Other criticisms were made.

It is fair to conclude from all this discussion that the real extent of losses in the bank is unknown, but what is clear is that the provisions for loan losses were understated, some banking and accounting practices were unconventional, and that CCB was in a bad condition which appeared to be terminal.

E. CCB CESSATION OF OPERATIONS

1. Appointment of a Curator

The Minister of Finance had been advised on 8 July that: "There is sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now". It is not entirely clear from the record, however, when concrete steps were undertaken within the OIGB to prepare for the possibility of collapse. The decision making during the early summer was incremental rather than comprehensive, and the alternative possibility of a merger appeared to be open until mid-August. When asked whether the machinery to appoint a curator was activated on 13 August, the date of McLaughlan's presentation in Ottawa, the Inspector General replied:

> By July 10 I was talking to the Alberta Government about what alternatives might work because the situation surely did not look good, and there were no easy answers.
>
> We were actively seeking other alternatives, and by August 13th we were beginning to plan for the possible liquidation of this bank, yes.
>
> ... [W]hen you are dealing with banks and the confidence of the system, you simply do not wake up one morning and decide that today we are going to close the bank. There is a lot of preparation that needs to be made, and you want to make very sure that you are not making any mistakes about this, that the evidence is indisputable and that the alternatives have been adequately canvassed.
>
> We were very much in that stage by August 13.

The OIGB's exhibits contain no memoranda to the Ministers between 25 June and 23 August, and no reference during this period to arrangements for a curator, but the Inspector General and the Minister of State were both present at several meetings during the first half of August when the process was discussed. On 23 August, the Inspector General prepared a memorandum for the Minister of Finance and the Minister of State regarding the CCB and the Northland Bank "to outline proposals for action to deal with the mounting difficulties the banks are facing." He advised the Ministers:

> I am now convinced that solutions must quickly be formed to enable the assumption of control of both banks and their eventual disposition.

Also on 23 August, the Inspector General prepared a separate memo to the Minister of State. In these two memoranda the Inspector General reviewed the options then considered to be available; amalgamation, slow liquidation, and fast liquidation. He discussed the advantages and disadvantages of each and indicated that his own preference under the circumstances was for the appointment of a curator, provisional liquidator and liquidator leading to the winding-up of both banks.

The treatment of uninsured depositors emerged as a key issue in the deliberations of late August. While this is not an issue with which this Inquiry has been directly concerned, it is appropriate to note that public statements by Ministers and public officials supportive of the CCB were regarded by some commentators as a foundation for compensation claims by uninsured depositors.

At the time of the bailout, the Minister of Finance and the Minister of State (Finance) both expressed confidence in the condition of the CCB. The Minister of State (Finance) stated:

> In consultation with the support group, we are satisfied that this bank is now a viable bank, that it will be profitable in the future, and that we will be repaid, as will other members of the support group.

The Minister of Finance told the House:

> It is for that reason [the impact on Western Canada] we felt it important to do everything we can to ensure the ongoing viability of the bank. We believe the support operation that was put together over the weekend will achieve that.

Governor Bouey, on Sunday, 25 August in a meeting with the Ministers and by letter of 28 August, argued for compensation of uninsured depositors. The Governor of the Bank of Canada, in discussing with the Ministers the issue of compensation of depositors, reveals an assessment of the age of the causes of the failure of the CCB. He said:

> ... evidence [is] now becoming available that demonstrates clearly that the causes of the present situation already existed at the time the official assurances were given. ...

Following the decision to liquidate the CCB and to provide compensation for uninsured depositors, a number of the banks which had participated in the Support Program stated their claim to compensation on the basis of the understanding associated with the Memorandum of Intent and Participation Agreement. In the event, the banks were not compensated for their contribution to the Support Program for CCB. Bill C-79 providing compensation for uninsured depositors was introduced on 3 October 1985.

2. The Decision to Collapse CCB

As of 1 September 1985, Bank of Canada advances to the CCB amounted to approximately $1,310,000,000, or about 65 per cent of the total outstanding deposits of approximately $2.2B. The Inspector General wrote Governor Bouey on 1 September to advise him as follows:

> Based on continuing surveillance of the Canadian Commercial Bank by my office and on the information available to me, I have concluded that the Canadian Commercial Bank can no longer be considered a viable operation. Accordingly, I propose to report to the Minister under subsection 278(2) of the Bank Act that the Canadian Commercial Bank will not be able to pay its liabilities as they accrue, unless you advise me that the Bank of Canada intends to continue to provide funding so that such a report would be incorrect.

In reply on the same date, Governor Bouey stated:

> In the light of the information which you have conveyed to us in your letter, it is clear that the problems experienced by the Canadian Commercial Bank cannot be solved through the provision of liquidity, and we therefore are ceasing immediately to provide advances.

The Inspector General continued the "anvil chorus" on 1 September, reporting these developments to the Minister of Finance and the Minister of State (Finance), and recommending to them that a curator be appointed forthwith:

> In these circumstances, I am reporting to you that I am of the opinion that the Bank will not be able to pay its liabilities as they accrue.
>
> I recommend, therefore, that you forthwith appoint a curator to supervise the business and affairs of the Bank pursuant to subsection 278(2) of the Bank Act.

On the same day, the Minister of Finance took steps to appoint a curator for the CCB. The firm of Price Waterhouse was named as interim liquidator on 3 September.

Press releases dealing with the CCB and Northland Bank together announced the actions that had been taken. A press release from the Bank of Canada indicated that the Bank had "concluded that there is no longer a basis for further liquidity support of these two banks and accordingly is ceasing immediately to provide advances to them." The press statement also reported:

> The Governor stated that the difficulties experienced by these two banks do not reflect on the soundness of the rest of the Canadian banking system. He also reiterated that the Bank of Canada stands ready as always to provide liquidity if requested for any Canadian bank.

The Department of Finance press release confirmed that the Minister of Finance had taken action to appoint curators for both the CCB and Northland Bank. This release announced details for the transition in management effective 7 p.m. EDT, Sunday, 1 September, and described depositor reimbursement procedures to the maximum CDIC limit of $60,000 including interim efforts "to endeavour to make funds available in modest amounts to those insured depositors who find themselves facing serious and immediate financial hardship."

Appendix E

Formation and Evolution of the Northland Bank

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Appendix E

Formation and Evolution of the Northland Bank

A. THE ORIGINAL CONCEPT AND ORGANIZATION OF THE NORTHLAND BANK

The founders of the Northland Bank shared the conviction of their counterparts at the Canadian Commercial Bank that distinctive needs of the prairie economy were not adequately served by existing financial institutions. They proposed to emphasize, as background documents on the Northland Bank demonstrate, "imaginative and innovative approaches to the financial aspect of economic development in the prairie provinces." It was intended that this specialized services approach would "from the very earliest moments of inception, allow for and permit the maximum input and impact (with due recognition of what is prudently possible) on the economy of the Prairie Region."

The original Northland Bank proposal as presented to Parliament was that the bank would be initiated and financed by cooperatives and credit union societies in western Canada. These funding organizations included cooperative insurance companies, cooperative credit societies, cooperative trust companies, as well as retail and wholesale cooperatives and a cooperative implement company, all located in the prairie provinces.

Mr. R.A. Willson, a founding director and first Chairman of Northland's Board of Directors, had been retained by the bank's promoters to study the concept in depth. Willson concluded that although the credit unions did not wish to enter the commercial lending field, they were prepared to make their retail deposits available to Northland for commercial lending. Credit union deposits were expected to provide a secure line of liquidity for the bank's commercial lending in the very early stages. Unfortunately, credit unions' deposits were not made available to the extent that had been anticipated because of a subsequent change of plans on their part.

As originally conceived, Northland's lending policies were to be directed towards assisting the expansion of the national economy with "special emphasis on the rapidly growing needs in the prairie provinces". The sponsors of the bank advised the Parliamentary Committees that the major business objective of the bank would be to concentrate upon industrial, commercial, and agri-business loans in the $200,000 to $2M range. Northland's planned lending orbit was concentrated on the prairies and its initial funding support from the credit union movement was gradually to decline in importance as new sources were utilized, so that in the long term, the credit union movement would be but a small participant in the bank. Lending funds, it must be emphasized, were not to come from retail deposits, but in the words of its Chairman, Mr. R.A. Willson, "we will be relying on our skill to buy and manage money as a wholesale bank". When the sponsors of the bank appeared before the Finance, Trade and Economic Affairs Committee of the House of Commons, the first President of the bank, Mr. Hugh Wilson, stated that the bank would secure its deposits from "the money markets across the nation" and from "bought deposits" from customers.

The President further explained that, while the founders could no doubt build a larger bank more quickly, they did not think it prudent to proceed at a faster pace which would see a total asset position of $343M at the end of five years. As will be seen from the subsequent history of the bank, this strategy was abandoned after the first one to two years, and major growth became the principal goal of the bank. Legislators were also repeatedly assured that the principal source of income would be interest from loans and not fees and commissions.

As in the case of CCB, the Inspector General of Banks appeared before the Banking, Trade and Commerce Committee of the Senate to record the fact that he had no objection to the passage of the incorporating Bill. The Special Act of Parliament incorporating the Northland Bank received Royal Assent and became effective on 20 December 1975. Northland received approval from the Governor in Council to commence the business of banking on 28 September 1976. The capital of the bank was authorized at $17M (1.7 million shares at a par value of $10). By December 1976, when operations were getting under way, 829,000 shares were outstanding and fully subscribed at $12.50 per share for a total paid-in capital of $10.7M.

Northland located its Head Office in Winnipeg and established executive offices in Calgary where its first full branch opened. It proposed immediate expansion to Edmonton, Regina, and Winnipeg by means of "development offices". In addition to R.A. Willson, the founding Chairman, and Hugh Wilson, Northland's first President and Chief Executive Officer, the original Board was heavily weighted with representatives of the co-ops and credit unions which had initiated the Northland proposal. Hugh Wilson came to Northland with almost three decades of domestic and international banking experience. He had branch office background in Manitoba, Saskatchewan, and Alberta, a range of senior management experience, and familiarity with the international environment from previous employment with the International Operation Division of the Toronto-Dominion Bank.

In an information memorandum dated December 1976, Northland presented a series of basic business policies which it intended to pursue in implementing its planned program of development:

1. Provide business in Manitoba, Saskatchewan, Alberta, British Columbia with operating capital and term loans, in keeping with regional conditions and needs.

2. Assist in the development of the Western Canadian money market.

3. Minimize consumer/retail services and the aggregation of savings deposits as a source of funds. Emphasize the purchasing of short and medium-term domestic and international funds in money markets at favourable rates to match loans.

4. Maintain firm control of the administrative, organizational and other overhead costs to offset any initial competitive advantage larger competitors may enjoy in purchasing funds at a lower cost.

5. Secure direct access to international and foreign exchange services through correspondent relationships with certain significant offshore and U.S. banking institutions, to enhance service to domestic clients.

6. Emphasize financial and management counsel to clients as a prime service feature.

7. Secure, develop and maintain managerial competence and experience to service natural resources, secondary industry, commerce and agri-business in Western Canada.

8. Adhere to a policy of sound asset/liability management to ensure flexibility and liquidity at all times.

B. THE EARLY YEARS OF THE NORTHLAND BANK

1. The Pattern of Growth — 1976 to 1982

Northland authorized its first loan on 15 November 1976. President Wilson, using the international connections he had developed before joining Northland, obtained invitations from major banks to participate in sovereign lending. As a result, Northland became far more heavily involved in sovereign loans than the original plan had intended; at one point, these loans reached about 50 per cent of the total loan portfolio. Through sovereign lending, the bank was able to deploy its capital quickly at reasonable rates and with little expense. As the spread on international lending was better than on domestic loans at the time, Northland's sovereign lending represented an attractive source of immediate income.

On 27 July 1979 (for reasons unrelated to Northland's international portfolio), Hugh Wilson's employment with the bank was terminated. Board minutes indicate that this was due to a deterioration in Wilson's relationship with other members of the management team attributed to perceived deficiencies in the President's personnel management capability. After Hugh Wilson left the bank, R.A. Willson became the President and CEO, in addition to keeping his position as Chairman. Chairman Willson has frankly acknowledged his lack of banking experience, and indicated that he had not sought the position of Chief Executive Officer of the bank.

The new President adopted an approach to Northland's growth which differed significantly from the slow and steady approach Hugh Wilson had explained to the Senate Banking Committee prior to the bank's incorporation in 1975. The annual inspection reports produced by the OIGB for the years 1977, 1978, and 1979 reveal that in the early years of the bank, Hugh Wilson had maintained a conservative stance and guided the bank along a path of steady growth. Beginning in 1979, the OIGB reports show that the bank had begun to emphasize real estate lending, in part because such loans were easier to put on the books. By 1980, the bank had shifted its emphasis in terms of size of loans. The tendency to grant larger loans is illustrated by a loan booked in 1980 to finance real estate development in the Cayman Islands in the Caribbean in the amount of $6M. This loan exceeded 25 per cent of the bank's capital as of 31 October 1980. The 1980 post-inspection notes of the OIGB confirm the shift in loan size. Northland's Vice-President, Credit, is reported to have indicated that:

> ... in the past the bank's emphasis was on servicing the smaller $100,000 loan but now attention was being directed to the larger credits up to $3 million with

particular concern for connections between related corporations and outside guarantors.

Even loans up to the $3M level were regarded by management as a constraint on the growth of Northland's assets in 1980. The 1980 post-inspection notes also indicate that R.A. Willson expressed the view that by working within a loan limit of $2 to $3M the bank was finding it hard to accommodate business needs and to maintain customer confidence. Management had concluded that there was an immediate need to attract more capital in order to accommodate the bank's growth potential. The growth in the bank's total loans for the period 1977-82 is set out in Table E.1.

Table E.1

Northland Bank Total Loan Portfolio 1977-82

Years	*Total Loans*
1977	$26.7M
1978	$81.9M
1979	$131.1M
1980	$206.5M
1981	$397.9M
1982	$509.6M

It may be of historical relevance to note the 1980 dismissal of Touche, Ross and Co., the auditors. In 1979, Don Heasman, the engagement partner, gave the bank a choice of a specific loan loss provision on a certain account of $400,000 or a qualified statement. After heated discussion at the eleventh hour, the bank made the provision. In a discussion between the OIGB and Willson, the latter indicated that he did not think that any of the bank's officers would be acrimonious toward the external auditors as a result of the position taken. The OIGB commented in their record of the event, "This may be true for Bob Willson though I did not get the same view elsewhere." During the course of the annual inspection for 1980, Willson expressed concern over the critical approach of Heasman on this credit. Willson believed that the problems with this particular credit, and the weak credit follow-up procedures generally, were characteristic of new banks starting out. There was about the same time a difference between the bank and Touche, Ross over audit fees. Touche, Ross and Co. were on the audit panel for the fiscal year 1980, but the decision to remove them had actually been taken by the Audit Committee on 3 December 1979, shortly after the 1979 audit. The delay of one fiscal year in removing Touche, Ross and Co. appears to have resulted from the time required to locate another auditor. In the spring of 1980, the Audit Committee was considering presentations of other audit firms. At the time when Touche, Ross and Co. was released, the OIGB did not feel that this was connected to the position that Touche, Ross took with respect to the large provision, because auditors are rotated from time to time as the law requires. In hindsight, the Inspector General testified that Touche, Ross were "fired" because they insisted upon this specific provision. Years later, when discussing the appointment of a curator, Willson stated that Touche, Ross had been "fired" by the bank.

After Hugh Wilson's departure in mid-1979, Northland began to search for a career banker to assume the office of President and to replace R.A. Willson. Eighteen months later, on 16 January 1981, Walter A. Prisco joined Northland's management as President. Prisco had been a senior officer of Mercantile Bank and had a reputation as an excellent credit man. On 23 July 1981, Prisco also became Chief Executive Officer of the bank. R.A. Willson continued as Chairman of the Board.

Prisco found the Northland staff enthusiastic and ambitious. On the other hand, he concluded that leadership was weak and that few systems were in place to control credit authorization. In Prisco's view, great risks had been taken on and the quality of loans was substandard and inferior; 8 per cent of the portfolio was in serious difficulty.

On the financial side, Prisco planned to expand the loan portfolio by booking good business to reduce the proportion of unsatisfactory loans in the bank. He intended to proceed at a reasonable pace with the emphasis on quality and diversification. This would take the loan portfolio from about $400M in 1981 to $1B by 1984. Whether Prisco would have maintained his objective of a $1B loan portfolio in face of the deepening recession which began to set in at the end of 1981 will never be known, because Prisco was terminated in mid-1982.

2. Internal Control Systems

Northland, at least in its early years, lacked an effective internal inspection system. In 1978, an internal audit responsibility was established, and the post was filled by the Chief Accountant of the bank. It was not unexpected that his accounting duties were found to be more pressing than his internal audit duties. The office existed largely in theory. This continued to be a problem through 1981. Internal auditing personnel were mainly engaged in special studies rather than internal bank auditing and inspection. As a result, the internal auditors played a relatively minor role in the bank. The external auditors were not able to rely on their work in the conduct of the annual audit. Consequently, it was the auditors, not the bank's internal inspectors, who discovered major deficiencies in loan documentation, loan security held by the bank and approval procedures. Frequently the external auditors encountered an absence of the up-to-date financial statements and customer information which auditors look to in determining whether the borrower is in financial difficulty or loan recovery is otherwise at risk.

Prisco took a number of steps to remedy the problems he found in credit-granting practices and internal controls in the bank. Because the bank had tended to operate on an *ad hoc* basis in its day-to-day business, Prisco wrote a number of policies governing the conduct of daily business. He also established the office of Chief Inspector and clarified the loan granting procedures. To implement his reforms, Prisco virtually closed down new lending business in October and November of 1981, while problem accounts were isolated and appropriate reserves established.

On 8 March 1982, Prisco circulated a memorandum on credit to all officers of the bank:

> Our loan problems stemmed from poor credit judgement, faulty analysis, lack of foresight, and careless monitoring (follow-up) control, i.e. weak management. Some credit officers were shooting from the hip and didn't seem to realize that it's one thing to lend out money, but didn't think too much about the client's ability to repay.

The President went on to describe the bank as essentially an asset-based finance company and asserted that "Northland's credit granting record in its first five years of operation has been a poor one, by any standard". He admonished the staff to become more critical and banker oriented, and set out nine rules for the proper granting of credit which, in his view, had not been applied in the bank before his arrival. Henceforth, Northland was not to lend to anyone unable to provide up-to-date and audited financial statements, nor was credit to be granted on the security of the principal's residence. Credit officers were not to rely on replacement or historic value but should look to the economic value of assets in terms of their present and future cash flow. There were to be no realty lending unless cash flow serviced the debt, and no second mortgages. Prisco wanted to see "no loans without two ways out", "no more eleventh hour credit applications for answer yesterday" and "no more crystal-balling on rates". These rules were rudimentary and the fact they were needed in the bank reflects the new President's assessment of the state of affairs in the bank by 1982, and the quality of prior management.

In 1982, Prisco's relations with Chairman Willson and some Board members deteriorated. Disputes arose over two operational matters. First, Prisco introduced a proposal for the acquisition of a guarantee corporation. The corporation was financed by substantial shareholders and Prisco regarded it as a good acquisition for the purpose of obtaining capital. This led to the second matter of dispute. Because Prisco foresaw a potential loss on the Cayman loan mentioned above, as well as other large write-offs, he felt that it was necessary for the bank to increase its capital. Friction also developed on occasion from Prisco's belief that the Chairman required bank staff to carry out what the President considered to be worthless endeavours (one of which he described as a "dog and pony show" before the Regional Advisory Committees) during a period when they were urgently required to address the problems in the loan portfolio.

The Board disregarded Prisco's recommendations and voted against the acquisition of the guarantee company. Prisco, in an action which some Board members may have regarded as retaliatory, threatened to call a news conference to announce that "the bank would take a hit for $6 million" on the Cayman Islands loan. The Executive Committee terminated Prisco's appointment in June 1982 but resolved in a meeting two weeks later to propose to the Board that Prisco's lending skills and competence be retained by the bank. The resolution, strangely similar to the excuse for Wilson's termination, cited problems in inter-personal skills. In any event, Prisco departed and R.A. Willson again added the responsibilities of CEO and President to his work as Chairman. This time he held these offices until William E. Neapole, a banker who joined Northland in May 1983, became President in September 1983, and eventually CEO in August 1984.

Neapole's description of the early evolution of Northland's credit operations is consistent with Prisco's view that controls on the credit side were weak:

> In the late 1970s and up to 1981, Northland Bank participated in the prosperity of western Canada. During this period, Northland experienced strong, if not overwhelming demand for credit, primarily in the real estate development sector, which allowed the bank to earn generous fee income during the growth period.
>
> The overall strategy in retrospect was to grow as quickly as possible. Internal credit policies were more optimistic than prudent and the general euphoria of the day led to the granting of virtually 100 per cent of the loans that became later problems.

Criticisms about performance were also expressed by a director whose name was removed from the nomination list of directors in late 1982. This director stated:

> Let's talk about results for a minute in very succinct terms. After six years of the Chairman's management of the bank the stock is trading at a little over half of its issue price. The bank's earnings would be in a significant loss position if it wasn't for the mickey mouse treatment of taxes. Tell me any other business where you can book future profits, currently, especially when the same future profits are in substantial jeopardy for a number of reasons, one of which is the loan losses related to loans booked when the Chairman was directly in charge. I don't care what the auditors recognize, the bank simply did not make the money, and we can't spend it.

It must be noted, however, that this director had been associated with the guarantee company described above, and could have participated in the proposal for its acquisition. He would have received a $300,000 commission had the purchase gone through. Another Northland director resigned on 23 September 1982, again (according to Board Minutes) citing concerns about the performance of the bank officers, management, the executive committee and directors, and about a loan to a director and his associates.

3. Northland's Prospects and Financial Condition, 1982

Several assessments of Northland's prospects and financial condition were prepared in late 1982 by observers inside and outside the bank. Cumulatively, they indicate that Northland faced significant challenges to overcome the difficulties and weaknesses which emerged in its early years.

During his last tenure as Chief Executive Officer, Willson asked Northland's Chief Financial Officer to provide an analysis of the quality of the bank's interest income. The analysis indicated that the bank should reverse about $1M of interest that had previously been taken into income. This was done in the third quarter of 1982. Willson said that as a result, the bank went into a net loss position for the first time in its history.

Willson also requested the assistance of the Inspector General in finding a recently retired banker to provide direction and experienced counsel. The search was unsuccessful, but Willson was able to obtain, temporarily, the services of John McSherry, a recently retired Vice-President, Credit, of the Canadian Imperial Bank of Commerce. McSherry spent about three weeks analyzing the loan portfolio of the bank and examining the credit authorization process. He reported verbally to Willson that Northland's loan portfolio was risky, particularly due to the bank's concentration in real estate. He also reported that the bank management were competent and would not create further trouble. McSherry did not make a specific report on the level of loan loss provisions or on the level of nonperforming loans.

Files of the OIGB contain a memorandum "to file" dated 6 October 1982, dictated by a Bank of Canada employee. The agent for the Bank of Canada in Western Canada reported to an employee of the bank that "... he has heard from an institution in Calgary that has withdrawn $500,000 in funds from the Northland Bank because it did not like the profit picture of the Bank. When we visited the Bank last month we were assured that the Bank had not experienced any difficulties in attracting funds." No explanation of how this document reached the OIGB has been provided to the Commission, and there is no indication that any action was ever taken on it in that office.

The OIGB conducted a visit to the bank in October. OIGB files reveal that the inspectors raised several concerns as a result of their inspection. As of 30 September 1982, nonproductive loans stood at approximately $40M, or 7.5 per cent of all loans. There were substantial amounts of interest unpaid over 90 days which were still being accrued; the loans had not been classified as nonproductive. The inspectors concluded from their review of the reports made to the Board that the Board should have been apprised much more frequently about the quality of the loan portfolio. For example, on 25 March 1982, a report on noncurrent loans was made to the Board of Directors, but there was not another report until August 1982. The inspectors were also concerned to discover that a number of the noncurrent loans that were reported to the Board in March were apparently considered satisfactory by the following September because they had been omitted from the September nonperforming loans report, even though the amounts past due had either remained stable or increased, and the rationale for classing them current was strikingly similar to that described in the noncurrent loan report of 25 March 1982. This led them to conclude that senior management did not have full and sufficient knowledge of all loans in arrears in the bank. The inspectors were further concerned as to why this discrepancy existed at all in the absence of any improvement in the circumstances surrounding some of these loans. In addition, the OIGB inspectors reported that the value of collateral was not being adjusted to reflect deterioration in the economy. While the provisions for losses had increased substantially in the year, a number of accounts had gone many months without progress in reducing exposure and it appeared to the OIGB that more direction was required from head office in order to avoid any further losses. The inspectors also commented that an estimated $4.7M of interest taken into revenue either had not been paid or had been paid only through assistance by the bank. They commented that the policy regarding the accrual or reversal of unpaid interest allowed room for too many exceptions, and if continued, the inspectors noted, uncollected interest included in revenue had the potential to become unmanageable, particularly as the bank's own projections for the 1982 year indicated a net loss before tax adjustments of $4M. It was also reported that interest was being accrued for as long as ten months on some loans, and senior management of the bank were not sufficiently aware of all the loans 90 days or more in arrears.

The OIGB report based on the October inspection may be compared with a report by Mr. R. Tourigny, a private analyst, in September 1982. (This report was prepared at the request of one of Northland's directors. It was received by the Commission shortly before argument and was not subject to comment during the hearings.)

The analyst's report was based on financial statements (including quarterly statements) published by the bank, and on the writer's discussions of the bank in the money market community. The report summarized the views of "the better-respected analysts who had followed the Bank closely" as follows:

> i. The Bank urgently needs additional permanent capital.
>
> ii. A number of key staff have either left or are actively seeking employment elsewhere.
>
> iii. The noninterest expenses of the Bank are rising too rapidly for the business in place.
>
> iv. The loan loss potential is undoubtedly significantly higher than that which has been disclosed.
>
> v. Tax recoveries in the current year relate to the expectation of profits in future years, are not represented by cash, and are very reminiscent of the activities of the [name deleted] Bank.
>
> vi. The portfolio of preferred shares is only attractive to the Bank when it is in a taxable position. This is now some ways away and consequently the preferred portfolio is a cash flow drain on the Bank.
>
> vii. The Bank has always relied on fee income to boost income which does tend to repeat in buoyant times, but is very difficult to come by in hard times and is very difficult to get from quality borrowers. When any attempt is made to upgrade the quality of the loan portfolio, it is quite often at the expense of fee income.
>
> viii. It is an accepted fact that Mr. Willson is not a banker and there is concern that during a critical part of its life, the Bank lacks strong leadership and experience.

The analyst expressed reservations about a forecast by management which called for an additional $120M in loans to be put on the books in the fourth quarter of fiscal 1982:

> While there are still a number of borrowers looking for finance, the quality is not there. Quality borrowers are deferring capital expenditures in an attempt

> to repair their severely battered balance sheets and any attempt to expand lending at the rate envisaged over a three month period would be aggressive in the extreme and if further deterioration is seen in the existing portfolio, the Bank may well not have sufficient capital base to support the leverage necessary to write an additional $120,000,000 of loans.

Referring to the liability side of the balance sheet and the source of bank funding, it was stated:

> It would surprise me if the Bank is not already experiencing some slight difficulty in attracting deposits at fine rates which are, of course, the life blood of its operation. I noted with interest that according to a survey conducted on the 26th August (prior to the 3rd quarter earnings report) that Northland was offering the highest rate for funds out of twelve banks surveyed. In some cases, their rate was equal to other banks, but I think it indicates a higher cost of funds which of necessity will have a damaging effect on spreads and on the ability to write new loans.

The report then noted that the prior profits of the bank had in some years been the result of an application of tax credits under the *Income Tax Act*.

> While I understand that the banking industry in general is allowed to take credit for future tax relief into its profit and loss account and statement of retained earnings, I do not believe that the Bank's regulatory body will allow this to go on for an indefinite period. I also believe that the reaction of industry analysts will be very negative. I further believe that in any issue of securities potential buyers and underwriters would look at the net asset value per share on a break up basis and would not give value for the future tax credits.

The report further indicated that on the basis of the bank's statements, unpaid interest at the end of July 1982 represented 15 per cent of the total underlying loans:

> I appreciate that an amount has been recognized in the profit and loss account, but I am concerned that if things have been allowed to go on as long as they have, there may well need to be substantial write-offs against bad loans which could prove devastating for the balance sheet and to confidence in the Bank.

The analyst concluded that Northland's condition could only be alleviated with new equity capital. Accordingly, he discussed the problems of raising such capital through a secondary offering:

> ... it would be necessary for the board of directors to issue a full prospectus that would have to fully disclose the current position of the Bank and such disclosure would no doubt not only make an equity funding difficult and expensive for existing holders, in terms of dilution, it would also draw the attention of depositors to the shortcomings of the Bank's balance sheet and impair the Bank's ability to attract deposits.

Finally, the report calculated that an interest spread of 1.65 per cent at Northland would have been necessary to cover only overhead, and 1.98 per cent to break even in cash flow terms. However, when adequate provisions were made for loan losses and income recognition was placed on a sound accounting base, an interest spread of 3.10 per cent was required just to break even. Historically, however, the report observed, "The gross spread earned by the Bank would appear to have not exceeded 2.5 per cent", and on this basis an operating loss of $3.6M was the prospect for 1983. The report concluded:

> The problem is that the Bank does not presently have the capital base to support this level of business and needs approximately an additional $18 million to do so. ...
>
> If the Bank does nothing, it is difficult to see things improving as the fixed overheads are just too high for the business in place and lack of action could well erode the current position even further.

Willson requested H.G. Green, the Vice-President, Finance, to prepare a response to Tourigny. This response was circulated to the Board in late 1982, and argued that Tourigny prepared his report "from incomplete information base evidenced by the assumptions and opinions made". It is of interest, however, to note that many of Tourigny's conclusions were borne out by the evidence before this Inquiry, including the large turnover in senior management, the high undisclosed loan loss potential, and the heavy reliance on fee income to turn a profit. His conclusions are also roughly comparable to the contemporary conclusions of the OIGB. Perhaps this response to Tourigny was an early example of management's attitude that no outsider could truly understand Northland Bank.

C. NEW MANAGEMENT AND THE RECOVERY STRATEGY

1. The 1983 Annual Inspection

The OIGB annual inspection took place on 26 and 27 May 1983. A number of matters were discussed with various members of senior management and the auditors. First, Northland's new Chief Inspector, Mr. Stan Willy, reported that while he had only visited two branches since taking over the job in April, his ratings of loans were generally lower than those previously assigned. Willy also found that formal reviews of substandard loans were not up-dated on a regular basis, and that the system in place for identifying substandard loans was slow.

Second, the external auditors advised that they were in substantial agreement with the bank's loan loss provisions, and that they were satisfied that the amount of unpaid interest taken into income in 1982 was realistic. They also felt that the bank had been handling substandard loans with less firmness than in the past. However, more effort was being made to enhance managerial control over loans. The auditors also agreed with the observation of the OIGB that the inspection function had been largely nonfunctional since its inception, and it was not their intention to rely on the Inspection Department to any great extent for the 1983 fiscal year.

Third, discussions were held with Credit Department officers. Of note is the fact that the total number of reported substandard loans was $97M as defined by the OIGB, but only $66M as defined by the bank. The difference of $31M was made up of rearrangements of various kinds with the borrower, including reductions of interest rates; and sales of security to purchasers financed by the bank. In other cases, management of the bank simply expressed confidence in recovery of principal and interest and removed the loans in question from the substandard category. The OIGB concluded that while an improvement in loan quality was observed, Northland was somewhat less conservative than other banks in establishing specific provisions. For example, substandard loans were higher than other banks as a percentage of the portfolio but specific provisions were not. The bank was urged to be more conservative in making provisions for loan losses and in the recognition of unpaid interest income; unpaid interest then stood at $15M, of which approximately 50 per cent had been taken into income.

On 29 July 1983, the OIGB reported to the Minister of Finance on the Northland inspection as required by s. 246(2) of the *Bank Act*. The Inspector General advised that the provisions of the *Bank Act* having reference to the safety of the creditors and the shareholders of the bank were duly being observed and that the bank was in a sound financial position.

2. The Workout Strategy at Northland

Neapole had been at Northland for only a few days at the time of the OIGB annual inspection for 1983. He found the situation at the bank unsettled and somewhat disorganized. The loan portfolio was in difficulty caused, in Neapole's view, largely by the recession in Western Canada. Neapole also concluded that the existing problems stemmed from poor credit practices and weak management, although he disagreed with the emphasis that Prisco placed upon management problems as opposed to recessionary problems. The fact that the bank was almost exclusively funded by wholesale deposits, more than 50 per cent of which was obtained from investment dealers, was a further source of concern.

Martin Fortier, when he became a senior Vice-President in late 1983, was "shocked" by the condition of the loan portfolio. There was a large concentration in real estate, a lack of any concerted strategy to deal with troubled real estate loans, and the bank continued with the conventional banking method of "writing reports upon reports upon reports and no one ever dealing with any problems." There was some doubt in Fortier's mind that the bank would survive if some sort of strategy was not implemented.

In the continuing recession in Western Canada, the bank believed it essential to develop a strategy that would be responsive to the economic situation of the day. In order to overcome the asset problems, Northland's management, under the direction of Neapole, developed a coherent strategy whose dominant purpose was to reduce the exposure to loss by increasing the productivity of problem loans. The strategy included several related components: additional capital, development of a retail deposit base, expansion of the loan portfolio to dilute problem loans, and "workout strategy" to add value to the problem loans. Generally, Neapole testified that in implementing Northland's workout strategy it was necessary to assign priorities to the various problems in the bank. The first priority was the loan portfolio, along with funding of the bank.

a. Capital

The acquisition of capital was a significant component of the workout strategy. Some additions to capital occurred before 1983. In August, 1980, a rights issue to existing shareholders had increased the subscribed capital to $17.18M. By the fall of 1983, the bank's capital base stood at approximately $38M. A private placement of 2.8 million common shares was closed on 28 November 1983, providing an additional $17.5M in capital. Immediately following the private placement the bank completed a one-for-four rights issue which closed on 16 March 1984. This provided an additional $8M capital. A debenture issue in February 1984 raised $15M. As a result of this program, aggregate leverageable capital was increased by $39.2M to $77.2M.

Discussions started in December 1984 which led to the filing in late February 1985 of preliminary prospectuses for publicly issued convertible preference shares and floating rate debentures, the total of which was contemplated to amount to $35M. The details of the events of early 1985 are discussed below, but the end result was that the preference shares project was dropped on 26 March 1985 (when the CCB rescue program was announced), and on 31 May 1985 a $16M private floating rate debenture issue was closed. In total, from late 1983 the new management team raised $56M of new capital bringing the total capital of the bank, including debenture debt, to $101.5M. The trend of capital, reserves and accumulated surplus of the bank is shown in Table E.2.

Table E.2

The Trend of Capital, Reserves, and Accumulated Surplus

	1980[a]	*1981*	*1982*	*1983*	*1984*	*Aug. 31 1985*
				($M)		
Capital (including retained earnings)	20.5	23.4	31.2	31.4	57.1	58.9
Appropriations for contingencies	2.0	6.1	7.1	8.5	11.6	11.6
Subordinated debt	—	—	—	—	15.0	31.0
Total	22.5	29.5	38.3	39.9	83.7	101.5
Retained earnings	0.11	.27	.63	2.0	2.1	

a. Fiscal Year ends

b. Retail Deposits

Using both its branch offices and agency networks, Northland embarked on a campaign to develop a retail funding base in 1983. This initiative was designed to reduce the bank's dependence on wholesale money markets. As shown in Table E.3, retail deposits grew from approximately $2.0M in 1982 to $90.2M in 1983 and $228.6M in 1984. They continued to grow to a peak level approximating $500M in July 1985, but then began to drop as a result of adverse press and broadcast coverage of the bank. This peak and trail off is not reflected in Table E.3, which shows the historical trend of deposits over a longer time frame. The shift from wholesale to retail funding was largely inspired by a liquidity crisis in early 1983 brought on by trouble in CCB during the Trust Companies Affair. As mentioned in Chapter 5, the cost of the retail deposits eventually made the program unattractive as the interest spread virtually disappeared.

c. Growth

The combination of increases in retail deposits and capital permitted Northland to address the problems in its loan portfolio. On the lending side of the bank, the strategy had two major elements; growth and workouts.

Table E.3

Northland Bank: Retail and Wholesale Deposits

	Wholesale	*Retail*
	($M)	
Oct. 1981	475	0
Oct. 1982	590	2
Oct. 1983	600	90
Oct. 1984	750	225
Aug. 1985	250	450

Until 1983, the bank had never ventured east of Winnipeg. The bank now decided to diversify into southern Ontario. In August 1983, the bank established a Toronto office as a money market operation. Lending operations commenced shortly thereafter. By September 1985, the office had booked approximately $76M in loans. Total bank assets grew from $652.9M in 1982, to $741.7M in 1983, to $1,080.6M in 1984, and $1,372.1M as of 31 August 1985. Northland loans grew at similar rates, rising from $510M in 1982 to $622M in 1983. In 1984, loans totalled $945.8M and reached $1,183.2M at 31 August 1985. Table E.4 illustrates the overall growth rate in assets after Neapole joined the bank. Northland's growth rate raised some concerns on the part of the OIGB and resulted in conflict between the bank and the federal supervisors. This is discussed below.

Table E.4

Northland Bank: Asset Growth May 1983 to May 1985

May, 1983	$700 million
December, 1983	$800 million
May, 1984	$900 million
August, 1984	$1000 million
March, 1985	$1100 million
April, 1985	$1200 million
May, 1985	$1300 million

d. Workout Arrangements

The other component of Northland's strategy on the asset side was the workout approach to problem loans. Management established the Senior Management Assessment and Recovery Team (SMART), composed of senior line credit management, with a mandate to reinstate productivity of problem loans and thereby protect the bank's position. Northland Bank essentially required time to improve the portfolio and repair the damage which existed in 1983. An asset management strategy using a variety of workout schemes was developed. A cornerstone of the 1983 strategy was that income would be recognized, and decisions would be taken on whether or not to establish a loan loss provision, on the basis of the future values (the added value), rather than current values, of the assets underlying the loans as security. This future value would be determined with reference to a period of time, approximately three years, depending upon the circumstances of each individual loan in relation to the specific plan for the workout strategy on that loan. This strategy was based on a number of fundamental assumptions. Neapole required "system tolerance", which essentially boiled down to disclosure of the strategy to the regulators and the auditors without adverse response on their part. Second, there had to be improvement in the economy. Neapole testified that the bank would require a "reasonable economy" to survive; that is, a gradual improvement, although not a return to prices which existed during the boom period.

Like the CCB, Northland Bank employed aggressive policies in relation to the accrual and capitalization of interest. In some cases, new borrowers either bought assets from the bank or one of its subsidiaries after the asset had been realized by the bank upon default on the loan. In these cases, the bank's exposure would be increased and interest was brought into income by capitalization, usually by way of a working capital loan to service the interest. Management stressed that the key test of the propriety of interest capitalization is the ultimate collectability of the loan, both principal and interest. They stressed that this practice was common to other banks. However, it is important to recognize that in Northland Bank, the banker's judgment as to the ultimate collectability of the loan was based on the added value or investment value. The propriety of this concept is considered elsewhere. No figures have been compiled on the total amount of capitalized interest. Most of the purchases from Epicon (a workout vehicle examined in greater detail below) were wholly financed by the bank, with an added debt-servicing component. A review of the auditor's working papers reveals that often shell corporations bought the old assets that had been obtained by Northland Bank through foreclosure proceedings, without any guarantors or additional security.

Workouts undertaken by this bank were similar to those undertaken by CCB. In certain cases, the bank would foreclose on a property, or appoint a receiver and sell the asset at book value to a borrower financed wholly or substantially by the bank. In one case, the underlying asset went through two receiverships and was on its fourth borrower. Each turnover of the loan further exposed the bank because financing would include an amount to cover interest unpaid by the previous borrower, and to service the debt in the future. The final borrowers, however, did invest a small amount of equity, and after the sale out of the first receivership, the bank took an actual write-off of about $500,000. The most recent loan also involved very favourable financing. It was on a five-year term, starting with an interest rate of 2 per cent, increasing by 2 per cent per year, to a 10 per cent ceiling.

The bank also had a propensity to undertake workouts resulting in extremely large exposure in relation to the bank's capital. The most spectacular example is the Cayman Islands loan referred to earlier. With the assistance of Walker and Wettstein, two real estate developers who often assisted the bank with workouts, the land was purchased by a joint venture company known as Ellesmere Cayman Ltd., held 9 per cent by the bank and 91 per cent by Ellesmere Developments Ltd., a company owned 80 per cent by Agra Industries Ltd. and 20 per cent by Walsten Management Ltd. (which in turn is owned equally by Walker and Wettstein). The group then decided to create a resort consisting of a world-class hotel, golf course, and condominiums. The bank managed to increase its total exposure to $56M (U.S.), $11.25M (U.S.) of which was nonrecourse. No specific provision was ever taken on this loan. In fact, when the foreclosed property was transferred to the bank in 1983, the bank took the opportunity to recognize some $600,000 of previously unrecognized interest income. That income, on the evidence, was never reversed.

In another case, the bank loaned $12.5M against the security of a hotel in Edmonton. The hotel did not do well. The quality of its management was suspect and the entire project was over-leveraged. The Chief Inspector of the bank thought that the security was not strong, and that cash flow was deficient. In addition, its prospects were considered dim, as there was already a hotel district, somewhat removed from the location of this hotel, but on the same thoroughfare. Nevertheless, the bank committed an additional $17M for the purposes of renovation. The exposure was eventually driven to $29M.

The bank undertook mergers between real estate properties and oil and gas properties. Fortier described the essence of these deals as follows:

> ... you could inventory the real estate for a period of time, get a reasonable market return ... and ultimately work on the real estate, get the returns up and dispose of it and still have an acceptable pay out on your oil and gas investment.

The bank also incorporated, or caused to be incorporated, new corporations to aid in or to conduct the working-out of problem loans. The first such corporation was Epicon Properties Inc., created as a "bank service corporation" as defined in s.193 of the *Bank Act*. The function of the company was to design and administer workout programs for nonproductive real estate assets held as security or foreclosed by the bank, thereby reducing the demands on the bank's lending personnel (who were not in any case experts in the management of real estate), and allowing them to concentrate on the development of new lending.

Epicon was in existence as a concept before the arrival of Neapole, having been developed by Fortier, Walker, and Wettstein. The two latter individuals, who did not appear at the Inquiry, were real estate developers considered to be expert in such salvage operations. The company was owned 55 per cent by Northland Bank and 45 per cent by Ellesmere Development Ltd. There was $100 of common share capital. Further details of the company are found above in this Appendix and in Chapter 5.

The technique employed and the accounting treatment in the bank's records for Epicon transactions were as follows. Real estate assets (resulting from realization upon soft loans) were transferred to Epicon at a price established as the lesser of appraised value (as established by Walker and Wettstein), and the aggregate of amounts owing to the bank as principal, interest, and fees, payable by redeemable preference shares to be issued to the bank from the treasury of Epicon. Therefore, the maximum price paid by Epicon was the loan principal plus interest due and legal fees. While in some cases fair value was established at a lower amount, and was the price payable by Epicon, in most cases, the fair value exceeded the value of the loan plus interest that had previously been reversed or was currently accrued. As a result of the transfer to Epicon, it was possible to recognize all such interest as ultimately collectable. Through this method, approximately $850,000 of interest that had been reversed in 1982 was reinstated in revenue for 1983. A similar amount of interest which had been reversed early in 1983 was likewise reinstated, for a total reinstatement of interest income in 1983 in excess of $2M (there is some evidence that the figure is closer to $3.5M) although no moneys were received by the bank from the borrowers.

Because Epicon was consolidated in the financial statements of the bank, beginning in 1983, these financial statements did not disclose the difference in accounting treatment enabled by the revaluation of the properties. The assets transferred to Epicon remained on the bank's books but appeared in the financial statements as a replacement loan without being so labeled. Interest cannot be accrued on replacement loans. However, the increase in value through foreclosure and transfer allowed the bank to reinstate or recover accrued and reversed interest. It was the position of the bank's auditors that Epicon had no impact on accounting; it was the realization of the loans into "hard" assets which allowed the recapture of interest including that which was reversed in one fiscal year and reinstated in the following fiscal year with no new moneys coming into the bank from the borrower. Over the life of Epicon, assets representing security for $99.393M of loans were transferred from the bank to Epicon in this manner.

As mentioned above, Epicon's mandate was to improve the properties and sell them. The 1984 annual report stated that of the approximately $70M of real estate assets placed in Epicon, some $40M had been disposed of successfully. It did not report the amount of bank financing required to effect disposal. The 1985 Debenture Prospectus, discussed below, disclosed that the bank had provided loans to "essentially all" purchasers from Epicon. As of 31 August 1985, properties totalling $75,851,791.00 were sold by Epicon to purchasers financed by the bank. Northland financing amounted to $71,910,791.00 of purchase price loans, plus authorized additional loans of $35,864,736.00 to service the loan, and for other expenditures such as the development of the property and the take-out of prior charges. By 31 October 1985, five properties remained in Epicon with a book value of $15.5M and a market value of $6.8M as estimated by the curator. Epicon suffered a loss in every year of its operations.

The nature of the Epicon transactions was disclosed to the OIGB as early as 28 October 1983, when Courtright, an officer of the OIGB, contacted one of Northland's auditors. He was told that Northland would take interest on loans into income until such time as the capitalized value was equivalent to the "investment value" of the property in question. The OIGB was concerned that the "investment value" (the transfer value) would justify the capture of income that had not been previously recognized. Courtright, having discussed the matter with Northland officers, wrote:

> It is difficult if not impossible without a much greater knowledge of the details of each transaction and of the practices followed by other banks to state whether or not the Northland recovery of such interest income is out of line with general practice.

However, the OIGB believed that the underlying concept of the arrangement was probably sound. The Inspector General stated to the Inquiry:

> The establishment of Epicon we welcomed, as it was explained to us, but we did have a lot of trouble about the price at which the assets were transferred to Epicon and there was much discussion about that with the bank and with the auditors.

The bank's auditors have testified that the recapture of income would have occurred whether or not the Epicon transaction was undertaken. The OIGB officers, in the course of testimony, differed with this opinion; the value of the assets would be frozen on the books of the banks at the time interest accrual ceased. Their position would appear to be that while the assets were carried on a consolidated basis as loan replacements, the transfer enabled them to be carried at a higher amount than they otherwise would have been. The evidence is that, in most cases, the valuation of the transferred real estate exceeded the loan principal plus accrued interest and legal fees. Accordingly, interest was taken back into income. OIGB testimony therefore suggests that the Epicon transaction gave the bank the opportunity to do something it could not otherwise do: revalue loan replacements, leading to a higher value on the asset side of the balance sheet, and at the same time increase the revenue of the bank without any new moneys coming from new or old borrowers. However, Northland did revalue properties and recognize income in cases where there was no transfer to Epicon (the Cayman Islands loan is an example), and this policy was adopted after extensive consideration by the auditors, who concluded that it was acceptable.

The Dexleigh and Hees transactions were similar to Epicon. Neapole called them the "logical and next step". Poorly performing assets in the amount of $53.9M were sold to Dexleigh Corporation at book value. The bank took security on all the assets transferred, so that each asset was cross-collateralized. It financed the $53.9M purchase of properties by Dexleigh and made available an additional $22.7M to refinance prior charges on the properties transferred if they could not be favourably financed elsewhere. In addition, a credit facility of $53M was made to Hees International Corporation, an affiliate of Dexleigh. Dexleigh gave the bank a $6M irrevocable letter of credit payable in four years. Both loans were to bear interest at the lower of bank prime minus one-half, and 11 per cent, and were for 20 year terms. The Hees credit could be reduced by conversion, at the bank's option, to floating rate preference shares (to carry a dividend rate of 70 per cent of prime rate) of Hees or its associated corporations. In response to the length and size of the loans and the interest rate cap, management took the position that the bank received an immediate improvement in its revenue in exchange for a "significant long term yield curve risk". It is interesting to note that some of the properties that were, or had been, with Epicon were included in the sale to Dexleigh. This tends to suggest that Epicon was not as successful as management claimed, and that it was not entirely proper to recognize loans to purchasers of Epicon properties as new and performing. This topic is pursued further in relation to the auditors in Chapter 5.

The Dexleigh transaction illustrates the resolve of management to reject, if necessary, the "wink and nod" approach of the OIGB. The Assistant Inspector General contacted Neapole in March 1985 to express his concern that the entire transaction aggregated a potential exposure of $129M. In response, Neapole pointed out that the transaction would upgrade the bank's existing position and that the Dexleigh transaction should not be grouped with the Hees transaction, even though they were obviously "associated companies". He pointed out that Dexleigh was a stand-alone public company with equity exceeding $100M. In response, in early April 1985, the Assistant Inspector General wrote to Neapole to obtain confirmation that the bank would provide to the OIGB the terms and conditions of the letter of credit to be provided by Dexleigh, and that it would only recognize income on the transaction as cash and would not accrue interest in excess of $6M (the base value of the letter of credit). On the same day, Neapole wrote to the Inspector General to state that the bank intended to limit its exposure to Hees to a maximum of 50 per cent of its capital account. Significantly, he went on to say:

> We do not feel it is necessary for your department to control the deal externally in any way that would require an amendment to our prospectus or our loan agreements, copies of which are enclosed. The relationship with Hees is excellent and I am satisfied that we will have their full cooperation.

And:

> I realize that once again, that we are asking you to see it our way. Nevertheless, I believe the justification is there.

The final matter of note is fee income. The bank's activities generated both conventional fees and merchant banking fees. The latter were the focus of extensive evidence because of the size of the fees, which could approach 15 per cent of the authorized amount of a loan.

It is instructive to consider the large increase in "other income" after 1983. While in 1983 "other income" (mostly fee income) was approximately $2.4M, this increased in 1984, and in the first 10 months in 1985, to $8.1M and $8.0M respectively. A very large percentage of this "other income" was in relation to loan activity and to merchant banking. Management argued that the percentage of "other income" to total income (other income plus gross interest income) was similar to the percentage found in all the big banks. This is in fact true. However, the composition of "other income" varies between the big banks and Northland Bank. Other income of the large banks is composed of fees from many sources, both retail and commercial, and includes service charges, credit card fees, loan and commitment fees, securities commissions, foreign exchange revenue, bankers' acceptances, letters of credit and guarantee fees, and sundry items. In contrast, Northland Bank's other income consisted primarily of fees taken in relation to loan authorizations. Further, none of the large banks experienced the huge increase in other income which Northland did between 1983 and 1984.

The maintenance of fees as an income source requires, of course, continuing loan growth, for without new authorizations such income cannot be earned. The pursuit of fee income deflects the lending standard away from the quality of the loan to the size of the fee. Thus, the practice almost inherently produces a loan portfolio of lower quality than in conventional banking. Northland's aggressive growth strategy in a recessionary economy suggests that some loans were made just to earn fees from risky borrowers who could not get loans elsewhere. For example, one transaction involved a loan to two borrowers for the purchase of a hotel site in Hawaii. One borrower owned some property in Hawaii, and the other borrower was a drug store in Alberta. The latter received $1.15M. The former got a loan to take out a maturing agreement for sale on the property in the amount of $3.528M, secured against the property. Other bits and pieces of the loan were secured on other properties, and the gross financing amounted to $5.59M. A fee was taken of $650,000. Management stated that the large fee was justified because the deal was difficult to structure, and there were time constraints involved. The other view is that the bank simply refinanced the property. The borrower was unable to obtain financing elsewhere. There was some debate within the bank about the advisability of granting the loan in the first place. Iain McLeod, the then acting Vice-President of Credit, opposed the loan. Fortier was in favour. Neapole broke the deadlock when he put on his "businessman's hat" as opposed to his "banker's hat", and approved the loan. McLeod testified that the only merit in the deal was the fee.

Northland management admitted that if they could not make an above average profit on a deal, they were not interested. Neapole said, "... we are not a cheap bank". Management justified their merchant banking fees by illustrating some deals which they considered extraordinary. In simple terms, the bank could create the environment for a deal by using in-house expertise or by conducting the negotiations. When this was done, the fee was characterized as a "merchant banking" fee, it was considered earned and would be taken into income immediately, rather than amortized over the term of the loan.

A fascinating source of fee income was discovered by the bank in late 1984. Loans were made possible by a Government of Alberta program under which the government provided a 30 per cent rebate of investment eligible under the program. The procedure, in its most simplified form, was as follows. The bank would provide a loan to a company that would invest, through intervening corporations, in a small business equity corporation (SBEC). The Province of Alberta, once it approved the investment, would grant 30 per cent of the investment to the investor. Northland typically made a $5M loan, which yielded a $1.5M grant from the government, of which approximately $700,000 was paid to Northland as a fee. Moneys advanced by Northland, or rebated by the government, were used to purchase Northland Bank term deposits. These deposits were then pledged back to the bank as debt servicing deposits to service the interest cost on the initial $5M loan to the borrower company. The bank made loans of this type of about $42M, earning approximately $5.5M in fees. There is evidence that the bank made appropriate deferrals of these fees.

Both Morrison, the liquidator, and Adamsons, an OIGB inspector, were concerned about the long-term risk. The funds in the SBEC had to be used to acquire minority positions in small Alberta companies within two years. The security would therefore consist of minority equity investments in small companies, and was considered to be risky and illiquid. It is notable that two of the nine SBEC corporations were owned by Wettstein. On occasion, the SBEC borrower would invest in another Northland Bank customer. As of July 1985, five proposed investments had been identified, and were projected to be made by 30 September, 1985. Of those five, four were intended to be used to pay down the debt of existing bank customers.

The bank also paid a fee to itself. In late 1984, it was decided to move to new premises. The move was a good business decision. In order to make the move, the bank made a loan of about $6.8M on a building to be purchased by a Liechtenstein Anstalt (the ownership of which was unknown) and secured by a second mortgage. The first mortgage was $4.2M. Of the $6.8M, $3.2M was paid to the Anstalt, $1.6M was placed in trust to service interest, $200,000 went to the real estate agent, and $1M commitment and tenant inducement fees were paid to the bank. The bank was to move into the building as a tenant, and its presence would support a valuation high enough to cover the total exposure on the building of $11M. There is some evidence that, in the absence of the bank's own tenancy, the building would be valued at approximately $7.2M. The added value derived from the bank's tenancy depends upon the viability of the bank which in turn was becoming dependant on deals like this one which provided a facade of income in the bank. This income, in reality, was the bank's own money set in circular motion by the deal. In that event, the loan exposure would not be justified and the bank would not be able to get those fees. An offer to purchase the building for $11M was made by another borrower of the bank as part of a complicated proposed loan to be made at extremely favourable rates. The bank took the tenant inducement fee into income. The impropriety of the situation, if any, is the same as in the case of the practice of capitalizing interest.

On paper, the workout strategy appeared to be vindicated. There was a favourable trend in net income and in revenue, which could lead the casual observer to believe that the bank was coming out of the recession successfully. Table E.5 illustrates the bank's revenue and net income for the past few years. In addition, the loan loss experience was apparently coming under control. Table E.6 illustrates the trend in actual loan loss experience and the provision for losses charged to the income statement.

Table E.5

Revenue and Net Income

Year	*Revenue*	*Net Income*	*Percentage Return Revenue*
	($ 000)	($ 000)	
1980	27,300	1,300	4.8
1981	68,700	400	6.4
1982	91,500	1,800	2.0
1983	77,000	2,900	3.8
1984	105,800	3,300	3.1
1985 (July 31)	102,700	2,100	2.0

Table E.6

Loan Losses

Year	*Actual Loan Loss Experience*	*Provision for Losses Charged to Income Statement*
	($ 000)	
1980	294	153
1981	1,720	1,258
1982	2,776	2,231
1983	4,491	3,292
1984	4,021	4,586
1985	N/A	4,841

The bank was showing a fairly significant drop in nonperforming loans from 1983 to 1984. In the 1984 annual review, the bank reported the following figures for nonperforming loans:

1980	$ 5M
1981	$10.6M
1982	$44.7M
1983	$99M
1984	$75.2M

The 1983 and 1984 figures include loan replacements, which in turn include $43M and $25M of properties carried by Epicon for 1983 and 1984 respectively. The 1984 figure does not include renegotiated reduced rate loans of $19M. The bank represented further improvement in the position of nonperforming loans for 1985. As of 30 June 1985, the bank reported $48M in nonaccrual loans. As of 31 July 1985, the figure dropped to $43M. These figures did not include the $54M of properties and loans transferred to Dexleigh, some of which were nonaccrual, others underperforming. The $54M transfer to Dexleigh, in turn, included $17M of Epicon assets.

The Rondix deal will be described below. Had it closed, it would have removed from the books of the bank a further $15.7M of Epicon assets and other loan substitutes, $27.3M of nonproductive loans or loans with a high probability of going nonproductive, and $57M of performing loans which were highly vulnerable to becoming nonproductive. The bank reported, in its interim statements for the third quarter 1985, that nonproductive loans after the sale would fall to $6.7M. The bank also described the transaction as a sale of virtually all its substandard loans to a private arm's-length corporation.

3. The 1984 Annual Inspection

Upon receipt of the first quarter statements for 1984, an officer in the OIGB noticed that the premises expense of about $1M had virtually disappeared. The bank had received a lease inducement payment for agreeing to move into a building some time in the future (the fee from the Anstalt transaction), which was being netted against the bank's current rent expense. The officer inquired whether this was appropriate and wrote, in a memo of 4 April 1984, "It is obvious that the bank desperately needs earnings and any accounting treatment which can show these will be employed."

The 1984 annual inspection was conducted by the OIGB on 17 and 18 May. The "going-in" concerns of the OIGB were "sharp asset growth resulting in additional borrowings from the major banks under a line of credit, funding adequacy, cost of funds, minimal liquid assets, quality and concentration of loan portfolio, and quality of earnings". The post-inspection notes of 22 June summarized the principal findings of the inspection:

> Bank's loan portfolio not well diversified. B.C. and Alberta (whose economies are still flat) account for 90% of all outstanding loan business. Real estate 32% and energy 10%.
>
> Bank relatively well run. Senior management has been upgraded since last inspection.
>
> Loan workout team — Senior Management Assessment and Recovery Team — confident that they can reduce nonperforming loans by year end.
>
> Although the Bank has improved its funding sources over the past year, sharp asset growth continues to place pressure on funding capability.
>
> Bank attempting to address funding inadequacy with retail deposit initiatives and looking at off-shore funding possibilities.
>
> Asset liquidity continues to be weak. The Bank regards its borrowing facility with the major banks as its major source of liquidity.

Nonperforming loans totalled $109.7M, or 15 per cent of the outstanding loan portfolio, as of 29 February 1984. An interview with senior credit personnel led to the observation that "good reductions in nonperformings expected over the next year, but about $48M 'hard core' would be around for some time". Actual loan losses for fiscal 1983 were $4.5M compared to $2.8M in fiscal 1982 and an estimated $4.0M for 1984. In terms of an overall evaluation, the OIGB rated Northland as "marginally satisfactory" or three minus on a scale of 1 (poor) to 5 (excellent). The OIGB concluded that management appeared to be doing everying to return the bank to a strong financial position. However, in view of the number of nonperforming loans, and the concentration of assets in British Columbia and Alberta, the task was described as "formidable".

The Inspector General testified that in the course of discussions with CCB officials, including Fortier and Neapole, he got "a relatively optimistic sense of the bank". He was impressed with the loan workout team and felt that management's work on difficult credit situations was supported by the external auditors. While it is not mentioned in the post-inspection notes for 1984, the Inspector General testified that he was aware that the bank's profitability had improved, but that this was due in part to the use of the concept of future values.

On 25 May 1984, the Inspector General provided the Minister of Finance with an up-date on banking in which he noted Northland's "gradual but steady progress from its loss position in 1983", and indicated his satisfaction that "the Bank is in a sound condition". On 24 September 1984, following the change in government, the Inspector General reported to the new Minister of Finance on the Northland inspection. The report notes that, during the past year, profitability of the bank had been weak due to narrowing spreads caused by a high portion of nonperforming loans, and by increases in the loan loss provisions. However, it continued, "[T]he Bank's performance has been improving, its profitability has improved somewhat and the Bank is making progress in expanding its funding sources. Assets have been growing fairly steadily and as a result nonperforming loans have been reduced in relative terms. A concentrated effort will be required by management to return the bank to adequate profitability. ... In my opinion", the Inspector General concluded, "the Bank is in sound financial condition but will continue to require close supervision over the near and medium term."

The reporting letter does not disclose to the Minister that Northland was rated "marginally satisfactory" at the close of the 1984 annual inspection. A covering memorandum to the new Minister advises that the OIGB provides details of the findings of the examination only in cases where banks have problems and require special attention. The Inspector General explained to the Commission that he had discussed the condition of certain banks, including Northland, with the Minister at the time of the change in government and stated: "The very fact of this separate letter denotes a concern and a special effort".

D. THE NORTHLAND BANK AT 1984 FISCAL YEAR END

A series of developments near the end of the 1984 fiscal year indicated that Northland's course and rate of progress towards recovery remained unsettled and occasioned some uncertainty on the part of outside observers. An administrative review, conducted in November 1984, listed several deficiencies in Northland's operations. The bank's auditors directed special attention to the areas of interest income recognition and the treatment of income from merchant banking fees leading to certain adjustments in these areas. Northland inquired of the OIGB regarding a write-off of loans, and concerns about funding came to a head.

1. The Hay Report

Despite many changes in personnel, the bank's administration remained a concern. Fortier commissioned Hay Management Consultants to conduct a "frank" administrative review of the bank in November 1984. Management intentionally solicited harsh criticism through their instructions to Hay Management. The major findings of the review were embodied in a report submitted to the bank in December 1984.

The report stated that the Northland Bank lacked a goal necessary to allow it to "continue to experience the uncommon levels of productivity and growth that it has enjoyed in recent years." Management attributed this finding to Northland's recent experience in a survival mode of operation: "We had to constantly adjust to external factors, constantly adjust our business plan, and it could be easily interpreted by junior staff that this was confusion".

The Hay report also concluded that Northland's "culture" was out of balance in that there was a lack of understanding and respect between personnel in its commercial, treasury, retail deposit, and administrative departments. Fortier concluded that this problem was commonplace throughout the banking industry where the view has always prevailed that "if you were not a deal maker, if you were not a lender, you were not really a banker".

According to the administrative review, Northland's internal systems were in a state of crisis. "The data processing resources of the bank are inefficient and ineffective". The report found "no evidence of a long-term systems strategy" and indicated that "the disarray is now stunting the flexibility and growth of the bank's operation". This problem was acknowledged by the bank management, who attributed the difficulty to the rapid expansion of Northland's retail deposit operations. They indicated that steps were taken to relieve the situation.

The last of the major findings reported by the consultants was that a state of crisis existed in Northland's financial management:

> Systems problems and accounting priorities have left a virtual void in the area of financial management. ... Branches and departments receive financial reports that are frequently unreadable or inaccurate. Responses to expense inquiries appear not to be effective. Asset management, liability management and GAAP management tools are primitive. Money market information is cumbersome and untimely. Competitive information is sketchy.

These limitations in the management information systems area were also acknowledged by management and immediately addressed.

2. The Audit Examination

Thorne Riddell was the managing or lead auditor on the audit for fiscal year 1984. During October and November of 1984, the Calgary partners of the auditing firm of Clarkson Gordon, the other of the bank's two auditors at the time, raised a number of questions with respect to the audit. These questions, relating to accounting for fee income and accrued interest, were directed to James Peers, a partner in the firm's Toronto office and a banking specialist. Peers was concerned that Northland was operating in a highly volatile economy and had had a good deal of trouble with real estate and oil and gas credits. In the result, he and his colleagues considered the bank to be in a risky position. It was decided that Peers would go to Calgary, which he did in the last week of November, in order to make further inquiries and to assess the situation. Michael Mackenzie, another Toronto partner actively engaged in bank auditing, subsequently attended in Calgary in the absence of Peers. For present purposes, it is sufficient to note that the result was perceived to be a "rigorous audit" of the bank's fee and interest income. The Inspector General was kept informed, and as will be seen, his impression of the event influenced his actions in 1985.

There is some question whether this incident affected the appointment of auditors for 1985. The domination exercised by this bank over its auditors and chief inspectors is described in Chapter 5.

3. The Write-down Proposal

On 15 November 1984, Neapole, Fortier and other senior members of the bank visited with the OIGB to propose a capital restructuring and write-down program along the lines which had recently been carried out by another bank. Specifically, Northland wanted to determine whether the OIGB would agree to a write-off of $50M in loans (the OIGB was advised in the course of the 1984 inspection that there would be $48M of "hard core" nonperforming loans around for some time) and a simultaneous capital injection. Management was also concerned by the fact that another bank had benefitted greatly from a similar program and that this would make the junior banks suffer by comparison, and wanted to know whether the Inspector General's approval of the other transaction represented a change in his view of long-term workouts. Management, in testimony before the Commission, denied that the meeting with the Inspector General implied that management thought that a write-down of $50M was in order. Rather, they said, the prime motivation for the meeting was to assess the Inspector General's views regarding long-term workout strategies, and to determine whether those views had changed. Any reference to a concrete amount for a write-down was, they said, hypothetical, and the bank had prepared a hypothetical computer model to explain how such a write-down might affect the bank. During the course of the meeting, Kennett asked management whether they were telling him that they had "a big hole in the portfolio", to which management responded that the figures were hypothetical. OIGB records tend to confirm the "exploratory" position of management. The discussions recorded were wide-ranging and this particular topic received no special emphasis.

E. NORTHLAND'S GROWTH STRATEGY, AND FUNDING ISSUES, 1985

1. The OIGB and the Growth Strategy

On 4 December 1984, the Inspector General wrote to Northland's President to comment on a strategic plan for 1985 supplied to the OIGB by the bank. Asset growth of 53.9 per cent was projected for 1985, following an increase of 43.2 per cent in 1984. The Inspector General was of the view that this rate of growth would be difficult to sustain in view of the funding difficulties experienced by the bank. He concluded that asset growth should be restricted until the bank could eliminate its reliance on the special facility provided by the big five banks or on the Bank of Canada. In a further letter of 29 January 1985, the Inspector General requested that Neapole make the Board of Directors aware of the OIGB's concerns. The Inspector General also proposed a meeting with the objective of securing an undertaking from Northland to limit growth until the bank's funding capability and liquidity improved to levels commensurate with its assets.

On 5 February 1985, Neapole responded as follows to the OIGB's concerns:

> While I am quite prepared to meet with you and members of your staff at any time to review and discuss the bank's current status and near term plans, I would resist strongly, entering into any undertakings to restrict growth beyond the type of assurances we provided to the big banks and to the Bank of Canada and Mr. Grant in our presentation. Certainly with us preparing a prospectus and about to seek a credit rating, I believe any customized regulatory constraints on the bank would be counter-productive and risk undoing a considerable amount of the repair work of the past 18 months.

On 18 February 1985, the Inspector General again wrote Neapole to advise that he would be in touch with him shortly to arrange a meeting to discuss the priority growth targets and liquidity levels. This was followed by a letter of 13 May 1985 from the Assistant Inspector General of Banks to Neapole, in which he underlined the OIGB's concern about rapid growth of the bank in the first five months of fiscal 1985. By this time, the share offering mentioned by Neapole had been withdrawn. The OIGB viewed the growth rate with "alarm", and indicated that considerable attention would be given to this issue at the upcoming inspection of the bank. The Inspector General testified that his office encountered much difficulty in enforcing its suggestions to this bank at the time:

> This was a different kind of situation. It was an extremely difficult situation. The fact is that we found it difficult to really put the screws to them.

This issue appears to have been concluded on 17 May 1985 when Macpherson called Chairman Willson to express deepening concern over the continuing excessive growth rate of the bank. Willson responded that he shared Macpherson's view on growth and funding, that Fortier had imposed a cap on lending and that the Executive Committee of the Board endorsed that cap.

2. Capital Issues

Northland Bank decided to take two issues to the market in 1985, a debenture issue and a preference share issue for a total target of $35M. The firm of Wood Gundy acted as underwriter for both issues.

Preparations to take the issues to market commenced in January 1985. A pre-"due diligence" meeting was held with bank management in January 1985, at which the underwriters considered the bank's liquidity and the level of its nonperforming loans as areas of concern. The underwriters were told that the current level of nonperforming loans was $73M, a decrease from $118M at the last year end. The bank described its strategies to deal with nonperforming loans, including the rapid growth strategy, the establishment of SMART, and the use of

Epicon. The underwriters were told that the auditors were supportive of the bank's strategies regarding Epicon, and that the accounting treatment of the Epicon arrangements was not improper. The underwriters were also aware that Northland was engaged in merchant banking. As a result of this first preliminary meeting, the underwriters decided to proceed, and a preliminary prospectus was developed.

Although the OIGB was concerned with Northland's rate of growth, and consequently with the bank's ability to fund itself, in February 1985, the OIGB remained optimistic about its general state. This optimism was induced in part by the "rigorous audit" of 1984 by the external auditors. In response to queries made by Wood Gundy, the OIGB put forth a positive view of the bank, and advised Wood Gundy that the liquidity crunch was attributable to environmental changes to a larger extent than to problems within Northland, that the level of nonperforming loans was high but the trend was encouraging, that the bank showed imagination and energy in dealing with asset problems, that the Inspector General approved of the Epicon philosophy, and that the Inspector General was happy with the bank's reporting and compliance with regulations. The general impression conveyed was that the Inspector General was aware of the bank's strategies for dealing with the specific problems of liquidity and nonperforming loans, was supportive of the bank's strategy, and believed that it was suitable in the circumstances.

The Inspector General testified that the OIGB was still "basking a bit in the glow" of the previous May's inspection and Mackenzie's visit to the bank. It is notable that the Inspector General testified that he was unaware at the time that assets sold by Epicon were 100 per cent financed by the bank, and that additional loans were being made for the payment of interest. The Inspector General was under the impression that the sales were normal commercial sales. At one stage, the Inspector General was told by Willson that loans were being sold by Epicon at book value. There was, therefore, clear evidence in his view that the bank was justified in transferring those loans at that value into Epicon.

On 20, 21, and 26 February 1985, further due diligence sessions were held by the underwriters with bank officers and the auditors. The underwriters were advised by the auditors that the bank's methods for determination and treatment of nonproductive loans were consistent with other banking institutions. However, the underwriters were also aware that Northland's business strategy was different from that of other banks, and that the bank was pursuing a strategy of workout rather than liquidation. They understood that one of the factors enabling the bank to pursue that strategy was the fact that it was a small bank and quite flexible. The underwriters have stated that they concluded from their discussions with the auditors that the first quarter 1985 fiscal results were accurate. This is contested by the auditors. They contend that the underwriters were advised that only limited review procedures on the unaudited interim financial statements had been performed, and that, based upon the results of such procedures, nothing had come to their attention which caused them to believe that the interim consolidated financial statements were not presented fairly in accordance with accounting principles prescribed by the *Bank Act* applied on a basis consistent with that of the last audited consolidated financial statements. The auditors further testified that the procedures they performed did not constitute an audit and would not necessarily reveal material adjustments which might be required to present fairly in the interim statements the financial position of the bank, referring to their standard form comfort letter.

The preliminary prospectus was filed with the provincial securities commissions and the OIGB in late February 1985. The underwriters continued their due diligence procedures, discussed various large loans with the bank management, and instructed their lawyers to review approximately forty of the bank's loan files. Then an event known as the "road show" occurred. This was essentially a marketing program. By Friday, 22 March, the underwriters had elicited a good deal of interest in the purchase of both the preference shares and the debentures However, the preference share issue was abandoned following the announcement of the CCB support package on 25 March, the underwriters having concluded that a preferred share sale could not be successfully completed at that time. On or about 19 April, the preliminary prospectuses for both issues were withdrawn. However, it was determined that a private placement for debentures could successfully be marketed. A confidential offering memorandum was signed on 22 April 1985. This method of issue is exempt from the prospectus filing requirements under s.154(a) of the *Bank Act* and from provincial filing requirements under the various provincial securities statutes. Accordingly, due diligence sessions continued with a view to closing a private placement of debentures.

To explore the potential impact of the CCB situation on Northland, the underwriters contacted the OIGB on 2 April 1985. The Inspector General described to the underwriters what had led to the bailout of the CCB, but restricted his description to facts known to the public at the time. He told the underwriters that he did not see any sign of a similar problem at Northland. At this point, the OIGB still believed assurances that the bank was having success in selling properties out of Epicon, and had the impression that such sales were normal commercial sales.

The underwriters again met with Northland's auditors on 1 April 1985. The auditors told the underwriters that the bank's mode of operation was one of workout, which had enjoyed some successes. The auditors were satisfied as to the financial presentation of the bank's operations for fiscal year end 1984, especially since Mackenzie had visited the bank from Toronto and reviewed some of the large interest income and fee income items. On 29 May 1985, the underwriters contacted the Assistant Inspector General. The annual inspection of the bank (described below) had been completed on 24 May. The Assistant Inspector General told them that the bank had a number of problems, but that it had a clear strategy and there was no reason to think that there were hidden problems. The OIGB was concerned with the fundamentals of the income statement: fee income exceeded net interest income for the first quarter of 1985, there was difficulty with the quality of the bank's earnings (but the bank had a plan to solve its problems and the OIGB would give the bank time to see the plans through), and in terms of the balance sheet, the values of underlying assets in Alberta were in question and loan loss recognition was somewhat lower than other banks. The OIGB was, however, accepting the bank's judgment at this stage. The underwriters also testified, and the same is recorded in their notes of the meeting, that the Assistant Inspector General stated that he was not aware of anything which would render it prudent not to close the deal. The Assistant Inspector General could not recall exactly what he had said.

In Macpherson's opinion, he was not telling the underwriters a great deal more than they could have deduced for themselves from publicly available information, except his statement that the OIGB would give the bank time to see its plans through. While the OIGB's concerns were disclosed, their general conclusion that the bank might need some form of assistance to survive was not. The Assistant Inspector General testified that he wished to restrict his comments to publicly available information because of the secrecy provision contained in s.251 of the *Bank Act*. The underwriters had been informed at the 2 April 1985 discussion that the OIGB was legally restricted in what could be revealed. The underwriters did not ask the OIGB specifically whether Northland was solvent. Macpherson did not tell Wood Gundy that the OIGB had classified the bank as unsatisfactory, or indeed, that the bank had been classified as "marginally satisfactory" the year before.

At due diligence meetings with the bank, the underwriters learned that Northland was considering paying down the credit facility from the major banks, and replacing it with borrowings from the Bank of Canada. They were aware that Northland expected to encounter difficulty in attempting to renew the lines with the major banks. One of those difficulties was that the banks would require their own due diligence examination of Northland. The underwriters were aware that publication of Bank of Canada advances could have adverse consequences.

In the end, the debenture issue closed on 31 May 1985, and $16M was "paid" into the bank, although as discussed in Chapter 5, the bank itself effectively financed the purchase of $7.5M of the debentures.

3. Northland Funding after the CCB Support Program

Immediately before the announcement of the CCB Support Program, and in response to a request from the Minister of Finance, the Inspector General provided information to the Ministers on Northland's current situation. The memorandum reported that "a rigorous audit of the bank's accounts, especially with respect to loan quality" was carried out by the auditors at the close of the 1984 fiscal year. The Inspector General outlined Northland's strategy through the planned asset growth to improve earnings, to diminish the proportion of nonproductive loans to total assets, and to develop noninterest sources of revenue such as fees for services and for commitment of funds. Northland had demonstrated improved profitability but had achieved "only about half the rate of profitability of all domestic banks". The Inspector General noted the impact on Northland of the recession which began in 1981, and outlined measures taken by the bank to solve its difficulty. He stated that the OIGB was maintaining regular contact with Northland and monitoring its funding activities several times a week. He concluded that "There has been no sign of liquidity problems lately."

By 22 March 1985, the Northland had used $10M of its revolving credit facility of $200M with the five largest banks, and had drawn down the whole of the $25M credit it had established with the National Bank of Canada.

The announcement of the Support Program for the CCB produced severe funding difficulties for Northland. Wholesale deposits placed by investment dealers dropped from $291M on 22 March 1985 to $121M on 29 April 1985. Wholesale money deposited directly by the customer fell by approximately 10 per cent between 22 March 1985 and 29 April 1985. Deposits from other banks, excluding standby facilities, dropped from $146M at 22 March 1985 to $84M by 29 April 1985, and stood at approximately $20M to $30M at the end of August. By 18 April, the bank lines with the major banks had been drawn to the limit. Bank of Canada advances commenced on 16 April 1985 at $85M, and steadily increased, as indicated in Table E.7.

Table E.7

Bank of Canada Advances to Northland Bank
April 1985 to August 1985

April 30	$85 million
May 31	$119 million
June 30	$339 million
July 31	$378 million
August 31	$540 million

Notwithstanding the CCB situation, Northland's retail deposits continued to grow. In April 1985, they increased by approximately $35M to $372M. They rose to approximately $510M at 9 July 1985. Retail deposits growth then started to flatten out, and ultimately, there was some decrease (see Table E.3). Adverse press coverage of the Northland Bank, commencing in mid-July, caused a further loss of wholesale deposits and brought to an end the growth in retail deposits. Neapole concluded in April that Northland was facing a long-term liquidity problem. The standby lines would no longer be adequate to allay the bank's need for Bank of Canada advances and the risk of further adverse consequences from the public disclosure of those advances. In view of the fact that the standby lines with the major banks bore higher rates of interest than Bank of Canada advances, Northland decided to terminate them. On 9 May, management visited the Inspector General to advise him of the proposed termination of the lines of credit. The Inspector General had no objection. On the same day, management met with Governor Bouey to discuss the move. The Governor concluded that it would be desirable to phase out the lines of credit over time in order to minimize adverse publicity, and recommended that Northland explore, with Allan Taylor of the Royal Bank, the possibility of prolonging some part of the lines of credit in order to assist the phasing out process. Taylor said there was no chance of the big five renewing the lines past the expiry date. Some of the major banks insisted that they be allowed to inspect Northland before credit could be extended but Northland objected. Two of the major banks' CEOs recommended that the lines be continued in order to preserve confidence in the market place on condition, however, that Northland arrange a joint hypothecation of assets with the Bank of Canada and the major banks. The Bank of Canada took the position that the lender of last resort role belongs exclusively to the Bank of Canada, and that while it was quite happy to see the other banks participate, if they wished to do so on a voluntary and unconditional basis (that is, without security and without inspection), the Bank of Canada would prefer to act as the only lender of last resort if special conditions were introduced. In the result, the standby lines from the major banks were allowed to expire on 15 June 1985.

It was during this time that Northland encountered what was described as a change in the basic rules and assumptions under which the bank had operated during the past two years. The change, Neapole stated, was reflected in the attitude of other Canadian bankers. Richard Thomson, Chairman of the Toronto-Dominion Bank, made a statement to a group of investment dealers, which subsequently became public, questioning the role of small regional banks and implying, in effect, that CCB should not have been rescued. Northland management also understood that the CEO of another bank had indicated in at least three meetings that Northland would surely fail. Finally, as mentioned above, some of the big five banks had sought as a condition of their extending credit to Northland, an opportunity to inspect it or participation in the OIGB's annual inspection. Ultimately, the standby lines not only expired, but the normal interbank "courtesy" bank lines of the big five banks were terminated by 28 May 1985.

F. INSPECTION AND CONTINUING SUPERVISION

1. The 1985 Annual Inspection

Management gave evidence that during the week of 8 April 1985, the bank sought and received assurances from its lead auditors and the OIGB that "the basic premise of going concern long-range values as were being clearly justified by the results of its workout strategies would continue to be acceptable". The Inspector General testified that he did not recall having given any such assurances to the bank, and that he never approved of "long-range values", although he stated the OIGB has always premised its view of assets on a going concern basis. Management further sought the assurance that the bank could continue with its strategies and efforts within a "constant (stable) framework", and the Inspector General agreed that, in April, such an assurance would have been a reasonable one for him to give.

On 8 May 1985, the OIGB advised the bank of its intention to extend its 1985 inspection to four days, the first two of which would be devoted to an intensive analysis of the bank's major credits by OIGB personnel and two individuals seconded from two major banks. These two individuals, Bruce Cockburn and J.R. Johnston, were the special representatives under the CCB participation agreement. Northland

Bank objected to the proposed arrangement, which it described as "a serious abuse of the regulatory process". Northland would not permit its competitors to have access to confidential client files, and the bank refused access to its records until it could be assured that the inspection would be carried out on the normal and traditional basis. Northland wanted it understood that the bank was to be regarded as a *bona fide* going concern and would be permitted to deal with its loan problems on this basis, that the results of the inspection would remain confidential as has been the customary practice, and that no member of the inspection team would be an employee of a competing bank, whether seconded or not. In the view of management, any deviation from normal regulatory practice would be a clear signal to the stock market and depositors that something was wrong at Northland Bank. The Inspector General took the position that the OIGB has the power in law to perform inspections in any way it chooses, but for some reason, the two seconded bank officials did not participate in the Northland inspection. The Director of the Inspection Division of the OIGB explained his interest in a fuller inspection on the basis that the OIGB had just been involved with CCB and had learned that the method of security valuation in use at that bank was on an "optimistic" basis. Therefore, it was deemed desirable to have experienced bankers examine the loans in the Northland portfolio. If these bankers had any reservations about the loan portfolio, the OIGB intended to undertake a full-scale inspection of Northland's credit files.

At the same time that it objected to inspection by seconded bankers, Northland provided to the OIGB an outline of the history of the bank, its workout strategy, and its concerns regarding a perceived change in the regulatory environment. The Inspector General could not recall reading this material, but presumed that he had done so. It was the evidence of management that they hand delivered this material to the Inspector General in the form of an appendix to a letter dated 13 May 1985. Management testified that the Inspector General had read the material and had made no comment.

The annual inspection was held on 21 through 24 May 1985. The office had the following "going-in concerns":

1. Asset growth was being financed through advances from the Bank of Canada.
2. There had been a decrease in the bank's net interest margin.
3. There was a 400 per cent increase in "other income" in the 1984 fiscal year to the point where it was the main income stream of the bank.
4. Need for timely recognition of losses.

5. Doubt whether the bank will be able to adequately build its general reserve by 1986 for its "sovereign" risks.
6. There was capitalized interest of $2.4M.

The "going-out concern" was described as follows:

> Our concerns prior to the inspection were intensified by our visit and we believe the bank may require some form of assistance to survive.

The OIGB rated the bank "unsatisfactory". The report noted that a policy of rapid growth had been adopted to dilute the effects of nonperforming loans, that the bank had elected to work out problem loans and not take losses that might otherwise be necessary, that in the workout process the bank accrued and capitalized interest, and that if fee income was not recognized as revenue, the bank could not report a profit. The OIGB was concerned about the degree to which the bank was using "investment value" in its security valuation in order to defend the absence of specific provisions for losses. "A substantial amount of loans are performing only because the bank declares them to be; unpaid interest is capitalized and/or accrued and taken into income." Interest margins or spreads had been decreasing since the second half of fiscal 1983 due to rising nonperforming loans and the higher costs of funds. Earnings were considered of very poor quality because of practices regarding the capitalization and accrual of interest, the small provisions, and the heavy reliance on fee income. The OIGB considered liquidity to be "nonexistent" since the CCB crisis.

2. Changing Views

The Assistant Inspector General explained to the Inquiry that "as the CCB affair unfolded and it became clear that perhaps the values that the CCB had attributed to some of the properties held as security were not entirely dissimilar to some of the properties that Northland had, it made the Office more skeptical of the values that Northland was attributing to the loans on their books in support of the continuation of interest income recognition".

On 18 June 1985, an officer of the OIGB, A.F. d'Entremont, reviewed the results of the annual inspection and recommended that Northland be given some sort of assistance in order to survive.

> In the long term, the biggest problem is asset quality. Non performing loans were 15.8% of the portfolio as at 31 October, 1983, reduced to 7.6% as at 31 October, 1984 and to 5.2% as at 30 April, 1985. However, much of this statistical improvement is due to growth in the portfolio.

Given the apparent success of the workout approach to date, and the fact that earnings were positive, d'Entremont recommended that assistance be in the form of a subsidy to support the bank's efforts to diversify funding sources. He suggested that assistance could be provided in the form of an interest-free deposit of $50M from the CDIC. Such a subsidy would enable Northland to increase its specific provisions and extend its branch network in order to increase retail deposit funding. It was also recommended that the growth in assets be capped at $1.5B. Unfortunately for Northland, this proposal was not acted upon. Rather, the time frame of Northland's workout approach would be shortened over the next month.

Participants in the Inquiry attributed considerable significance to communications between Northland and the OIGB concerning the bank's workout strategy, and to indications of the regulators' approval of the bank's approach to its difficulties. Management took the position that its workout strategy for marginal and unsatisfactory loans had been disclosed to the OIGB, and that the OIGB supported that strategy. The OIGB was, for at least two years, concerned with the bank's growth strategy, and its lack of conservatism in provisioning and the recognition of interest income. For the most part, the OIGB sought assurance from the bank's auditors that these practices were acceptable. The OIGB also received specific information on some transactions which disclosed or illustrated the workout strategy clearly. For example, it was advised, in late 1983, that the concept of "investment value" was in use in Epicon on a variable time frame of between one and three years, and was very thoroughly briefed on the workings of this company. The Inspector General testified about the trouble the OIGB had with the transfer values into Epicon. While the Inspector General testified that he thought the sales out of Epicon were normal commercial sales, in fact, it was reported in early 1984 to the OIGB that there had been a large swap of properties with a trust company which involved a large amount of bank financing, and in late 1984, it was reported to the OIGB that about 25 per cent of the dispositions had been by way of swap and that "outright sales accounted for about a 25% reduction in the portfolio". This information, as mentioned in Chapter 5, did not spur a further examination by the OIGB of Epicon's operations.

It was recognized by the OIGB as early as October 1983 that the bank was not a viable earning entity so long as it had to carry $100M of nonproductive assets out of a total asset base of $690M. At that time, the OIGB knew that the bank's strategy involved the restructuring of its nonearning loans in order to permit reclassification, and the dilution of noncurrent loans as a percentage of the total portfolio through substantial increase in outstanding loans. The difficulties with these approaches were recognized by the OIGB as early as October 1983 when Courtright wrote that the approaches could be more protracted than foreseen, require more provisions than booked, and be difficult to accomplish during the recession. In the concluding interview of the 1984 inspection, the OIGB approved of the new workout team (SMART) but cautioned the bank about rapid asset growth, and expressed concerns with asset quality, cost of funding and confidence. Subsequently, the evidence shows that the OIGB expressed concern to the bank regarding its growth rate, and sought an undertaking regarding the rate of growth of the bank. By the time of the 1984 inspection, the strategy that the bank was adopting had been made quite clear to the OIGB. However, there is no documentary evidence in the OIGB outlining a general understanding of the bank's practices in relation to the recognition of income and the taking of provisions, except for statements of concern regarding the accruing and capitalizing of interest. The Inspector General testified that recognition of income and provisioning was an area that always troubled the OIGB. However, no customized coherent reporting requirements were placed on the bank to determine exactly the ramifications of the various strategies.

Prior to May 1985, information regarding Northland's strategy came to the OIGB in a "piecemeal" fashion. Nevertheless, the OIGB was prepared to "see and live with the bank in an attempt to try and get through" the recessionary times, although it remained troubled by the need for growth. Prior to May 1985, the OIGB did not expressly advise the bank that it would at some point change its views as to whether it was prepared to go along with the bank's strategy. No one seems to have addressed the time frame of the bank's strategy. That may have been due to the expectation of many that the Western Canadian recession would be relatively short-lived. During the May 1985 inspection, there was a thorough discussion of the strategy, at which time the OIGB advised management that there was not much room in the loan portfolio to sustain income recognition and that the bank might be unable to continue to attract and hold retail deposits at the price they were having to pay. At the same time, the OIGB seriously doubted Northland's ability to generate fee income without further loan growth. In short, the OIGB concluded that time was running out.

This evolution in the OIGB's views of Northland's strategy is reflected in a meeting on 9 July 1985 at which the Inspector General discussed with the auditors the question of intrinsic values and suggested that time was running out. The recession in the West had been far more prolonged than expected, and there was no longer any reason to postpone the necessary action for another one to three years. It was time to start writing down loans to market value; time to "close the gap" was the expression used by Kennett in his testimony.

G. NORTHLAND'S SEARCH FOR A SOLUTION

1. Restructuring

As previously described, Neapole had concluded in mid-April that Northland had a long-term liquidity problem. Management continued to develop the bank's retail deposits and, on 10 July 1985, met with the Bank of Canada to discuss Northland's response to the effects of the CCB bailout on its funding. The bank presented projections for Bank of Canada advances, deposits, loans, and income to the end of the 1986 fiscal year. The Bank of Canada objected to Northland's use of liquidity advances to finance new loans, and obtained further assurances that Northland would not follow this practice. On the strength of these assurances, the bank's loan growth projections to the end of October 1985 were accepted. Northland's forecast that Bank of Canada advances would be reduced to $289M at the end of July, and to $188M by 31 October was, however, upset by a banker's "ultimate nightmare": press speculation, starting on 10 July 1985, precipitated a run on the bank. Neapole contacted the Minister of State (Finance) to arrange a meeting. Some solution for the loss of market confidence had to be found.

Management testified that as a result of the CCB bailout, the bank was facing a basic erosion of confidence, manifested in a loss of deposits and a fall in the share price. It would only be possible to restore market confidence by curing the liquidity problem and simultaneously dealing with the market perception of weakness in the quality of the bank's principal assets. Although management denied that Northland actually had a problem in asset quality, it recognized that, in banking, perception could become reality. Accordingly, management designed a proposal to meet the expectations of the market, which had recently seen the CCB and another bank take a large write-down in assets. Neapole and Fortier presented a major restructuring proposal to officers of the OIGB, the Bank of Canada, and the Department of Finance on 20 July. The proposal involved a capital component, an asset sale and government participation as follows:

1. $50M issue of common shares to the private sector;
2. issue of preference shares in the amount of $50M to be guaranteed by the Government of Alberta;
3. placement of a $20M, five year, interest-free deposit with the bank by the Government of Alberta; and
4. purchase by the federal government of a $250M segment of the loan portfolio, the proceeds of which would allow Northland to

write off some $50M in nonproductive loans, and make additional provisions for losses against other loans.

A second option suggested by Fortier included these elements:

1. placement of a large, interest-free deposit with Northland;
2. elimination of cash dividends on common shares;
3. renewed efforts to attract retail deposits; and
4. moderate loan expansion.

Minutes prepared by an official of the Bank of Canada state that the federal officials present on 20 July were of the view that Northland's current "liquidity and confidence problem did not warrant a restructuring proposal aimed at earnings, capital, and assets. Furthermore, the proposal, which would be viewed as a government bail-out operation, would heighten the perception that the true situation of the Northland, and of other small banks, was much worse than the public has been led to believe and could further undermine confidence in the Northland and possibly, in other small banks". Accordingly, the Minister of State (Finance) concluded that the proposed solution was not appropriate and premature. Before the meeting broke up, the Inspector General advised Northland that federal officials would meet during the next few days to review some measures to assist it, including a placement by the CDIC and Government of Alberta of noninterest bearing deposits with the bank, an attempt by the Inspector General to convince the large Canadian banks to restore normal banking relationships with Northland, and a possible press release by the federal authorities to reassure the public. The federal officials also discussed briefly, among themselves, the possibility of a merger between Northland and another bank.

The run on the bank continued throughout July. By August, Northland predicted a loss of a further $40M or $50M of wholesale deposits as they matured, and retail deposits were flattening out. A further meeting with federal officials was held on 1 August 1985. Officers of the Northland Bank, the Minister of State (Finance), other officers of the Department of Finance, the Inspector General, and the Governor of the Bank of Canada were present. The bank proposed that $260M of assets should be sold to a new company (owned by Gordon Dixon, a lawyer, and Chief Ron Derrickson, a director of Northland) which would be financed initially by Northland, and that this loan would then be syndicated to the Federal Business Development Bank and perhaps to the Alberta Treasury Branch. Northland would act as the agent bank of the syndicate, and provide $10M of the final financing, producing net receipts of $250M to the bank. In addition, a $100M interest-free loan would be made by the CDIC or the government to Northland, which would in turn be lent interest free to Epicon. Epicon would then purchase nonperforming loans of about $50M, plus another $25 or $30M of under-performing loans. By means of a Government of Canada couponless bond purchased out of part of the interest-free loan proceeds, the repayment of the loan to Epicon was to be guaranteed. Accordingly, it was said to be unnecessary to write down any of the related loan portfolio. The bank would at the same time endeavour to raise $40 to $50M of capital.

The Minister of State (Finance), the Inspector General, the Governor of the Bank of Canada, and G. King of the Department of Finance discussed the matter further in private. The 1 August proposal was rejected for essentially the same reasons as the rejection of the 20 July 1985 proposal. It was agreed that it could not be taken seriously and that a merger was likely to be the only feasible solution. Later in the day, the Inspector General informed management that the proposal would be rejected. By this point, the Inspector General had lost confidence in the management of the bank. Therefore, the only realistic solution was merger. He suggested that management consider a merger, and mentioned the National Bank as a potential candidate.

2. Rondix

Northland management, having concluded that they would receive no assistance from Ottawa, formulated the Rondix transaction. It was the position of management that this transaction would support existing recovery strategies by protecting the bank from the shortening of the acceptable time frame for long-term turnarounds. $100M of loan assets were to be sold to Rondix, the sale to be financed by the bank through an interest-free loan for a term of 15 years. The transaction had to receive certain accounting treatment to achieve the desired result on the bank's financial statements, but no accounting opinion was obtained. All this is discussed in detail in Chapter 5.

A meeting was held on 16 August 1985 for the purpose of discussing the Rondix proposal. At this point, the Inspector General had received the results of a special examination of the loan portfolio, and was concerned that the bank's income came predominantly from fees, that high risk loans were being made, that recovery on old loans was dependent on significant recovery in the Alberta real estate market, and that the bank was providing working capital loans to pay interest, coupled with 100 per cent financing of real estate workouts. In the opinion of the Inspector General, the bank could not carry on in such form. Willson, Neapole, Scarth (the bank's lawyer and a director) and Fortier joined the meeting. The OIGB outlined its concerns about the bank, questioned the bank's solvency, and urged it to contact the National Bank in regard to a merger. On the same day, the OIGB received a complete description of Rondix. The OIGB gave no opinion on the deal.

On 22 August 1985 the Rondix deal was presented to and approved by Northland's Board of Directors. Willson, the Chairman of the board, did not appreciate at the time that the entire value of this transaction to the bank turned on its the accounting treatment in the bank's statements. The Board had no opinion from any accountant that the arrangement would have the desired effect on the bank's statements. Management agreed that no opinion was sought from the external auditors. It was their plan to seek regulatory and eventually accounting indulgence by the fiscal year end.

On 23 August, Northland issued a press release about Rondix, and on that same day, John Crow, Senior Deputy Governor of the Bank of Canada, telephoned Neapole to point out that the loans to be transferred were subject to Bank of Canada security interests and, therefore, the consent of the Bank of Canada pursuant to the Hypothecation and Assignment Agreement would be required before disposition of the loans. Neapole agreed. The Bank of Canada then sent a confirming telex to the bank but never did consent to releasing its security in favour of Rondix. No representatives of the Bank of Canada were present at the 16 August meeting.

After the curator was appointed in September, an opinion on Rondix was obtained from senior bank auditors of the accounting firm Price Waterhouse. Essentially, the opinion stated that if the deal was as successful as it could be in theory, the bank would be left with an equity base of approximately $8M or $9M, calculated on the basis that the transaction would be present valued. In the worst case, the transaction would have left the bank insolvent in the amount of $18M. The opinion concluded that the accounting result sought by management could not be achieved. Assuming that the bank's auditors would have insisted on the same treatment, and that the bank had continued to operate, it would, as Neapole acknowledged, have finished the bank.

3. The Merger Option: The National Bank Review

Officers of the National Bank commenced a review of Northland on 19 August 1985 in connection with the possibility of merger. The

Inspector General was notified on 21 August 1985 that National estimated a necessary write-off in assets of $290M, an amount far in excess of the bank's capital. Much cross-examination was directed at the National Bank officer who testified, to demonstrate that the write-off would partly hinge on National's view of the market characteristics of loans it would be prepared to buy, rather than on the actual creditworthiness of the loans. On 23 August 1985, the National Bank advised the OIGB that it was not prepared to make or accept any offer for an amalgamation with Northland Bank as a going concern.

H. PORTFOLIO ASSESSMENTS

1. Cook and Adamsons

During the course of the 1985 annual inspection, two officers of the OIGB actually reviewed selected loan files of the Northland Bank. What they found indicated that there ought to be a follow-up review, and Northland Bank was advised accordingly. The review was to be carried out by Karl Adamsons, who had extensive experience in bank inspection and credit. Adamsons joined the OIGB in June 1985. His instructions were to review assets of the bank and make a determination of quality and adequacy of existing provisions. This was to involve a review of all nonperforming assets, all marginal, unsatisfactory and partially performing assets, and all other assets in excess of $2M. In addition, a sample of assets less than $2M was taken. Grant, the Director of the OIGB Inspections Division, instructed Adamsons that he need not visit the branches, and could limit his review to Head Office files. Fortier and Grant had extensive discussions about the proposed review. Adamsons was instructed to report to Fortier when he arrived at the bank, but did not have any instructions not to speak to anyone else. In carrying out his review, Adamsons limited his discussions to Mr. Guenette, the Vice-President of Credit, and did not speak to Neapole or Fortier, although he was free to do so. Because the review was restricted to Head Office files, Adamsons was unable to review actual borrower financial statements, receiver's reports, or appraisal documentation. Instead, he relied on the financial information submitted by branch officers to Head Office, along with the brief narrative which accompanied each credit application. For the most part, Adamsons relied on what he saw in the files. For example, where material on the file was insufficient in relation to security valuation, he would agree with the bank. In some instances, he admitted, he would arbitrarily discount the value of security where there was a lack of information in the file.

Adamsons reviewed Northland's loan files during the weeks of 15 and 22 July. His review encompassed $525M out of the total loan portfolio of $1.2B, as of 28 June 1985. The files reviewed were organized into six major classes.

Class A consisted of 31 loans with a principal value of $36.3M. Existing provisions were found to be $1.6M. In discussions with Guenette, it was agreed that these should be increased to $3.7M. Guenette testified that he only agreed to an additional provision of $1.55M relating to a single account. In any event, Adamsons suggested provisions on these accounts of between $5.6 and $6.7M. Capitalized interest amounting to $700,000 was identified.

The loans grouped under Class B, totalling $64.3M, were titled "potential nonaccrual loans". The majority were loans to development companies where the underlying value of the security was well below outstanding loan balances, and the interest was being either capitalized or accrued. Provisions of $4.4M were suggested, along with reversals of $4.6M of interest and $400,000 of fees. These loans were not classed nonaccrual by the bank.

Class C loans were those identified where Northland Bank had provided full financing. These were mostly in the real estate sector, and had a principal value of $254.8M. The security for loans in this category was thought in the long run on a going-concern basis to be sufficient to cover the outstanding loans. However, in a distress situation there would be a substantial shortfall. A significant portion of these borrowers could not service the debt, and if the Northland Bank were to discontinue its practice of providing working capital for debt servicing purposes, the loans would become nonaccrual. Commitment fees of $3.4M had been earned in the last twelve months.

Seven SBEC loans in Class D were reviewed, for a total principal amount of $32M, which earned fee income of $4.67M. Adamsons was concerned that the bank's security consisted of minority shareholdings in small business corporations, which had no other assets and only a nominal capitalization, and for which there was no likely market.

Classes E and F were considered to be acceptable in quality. Twenty loans totalling $84.1M in Class E were made to borrowers with positive net worth positions, a history of positive earnings and security that would provide full cover for loans. The Hees loan of $53M was an acceptable risk, but was classed separately because it was priced below the prime rate.

The report described a number of specific loans, followed by an overview of lending. Adamsons concluded:

1. Large portion of the bank's present problems can be attributed to excessive concentration in lending against marginal British Columbia and Alberta real estate projects. The bank is continuing this policy and frequently extends financing for the full cost of the project.
2. Workout policies frequently tend to increase the bank's exposure.
3. In the past six months, bank appears to be searching out projects that will generate high fee income, and it appears that analysis of the underlying value of the project and security is "given a back seat to fee income considerations".
4. Bank appears unwilling to make hard decisions regarding problem loans. Rather than accepting write-offs, workouts are pursued.

In wrap-up discussions with Guenette, the latter estimated that loan losses of $50M, $175M to 200M, or $300M would be experienced by the bank, depending on whether loan assets were worked out according to Northland's plan, sold in an orderly way, or sold in a quick wind-down of the portfolio. Adamsons noted that these comments represented a radical departure from Guenette's previous position that loan losses of the bank could be restricted to approximately $6M.

During the course of the hearings, Northland management, particularly Guenette, took exception to these comments. Senior management took issue with the comments attributed to Guenette by Adamsons. Guenette stated that he and Adamsons engaged in a philosophical discussion regarding the workout of relatively large loans (in terms of the bank's capital). While he acknowledged the accuracy of the larger figures, he stated that the $50M figure refers to the anticipated loan loss experience of the bank over a five-year period, and denied that it refers to an immediate required write-down of $50M.

In relation to 100 per cent financing, management argued that the acid test is the ultimate collectability of the loan. Virtually all of the 100 per cent financing was provided in workouts, and management argued that such financing was necessary as experts retained to work out problem loans do not put 25 per cent down and, management asserted, anybody who believes that they will is not living in the real world of commerce, particularly in Western Canada. Management also maintained that, in terms of materiality, the major banks do the same. Where the exposure of the large banks is small relative to their capital base, they take a very hard line. They take a different position in the case of large loans to borrowers such as Dome, Turbo or Massey Ferguson. Hence, management said, while there were many workouts in Northland Bank, a loan of $1M in difficulty, for example, would be of more significance to Northland than to the major banks.

Management also pointed out that Northland never took a fee on a restructured loan. In the case of new credits, they readily admitted that if they could not make an above average profit on a deal, they would not be interested. While Adamsons turned up certain fees which were much larger than the conventional negotiation fees he had seen in his previous employment, Northland's management took "merchant banking fees", which are much larger.

Northland management agreed that the bank had a heavy exposure in real estate, and provided full financing for projects, along with working capital. They also agreed that if the bank did not continue the practice of providing working capital for debt servicing purposes, a number of the Class C loans would have become nonaccrual. Given the accounting and financial consequences, this is a concession that the survival tactics of the bank were just that, and the only issues remaining concern who was not aware of this, and what damage was done by their attempts to save the bank.

Adamsons returned to Ottawa and reported to Grant, the Inspector General, and the Assistant Inspector General. On the strength of Adamsons' impressions, it was decided that a further review should be carried out. A second review was carried out 6 August to 16 August 1985, this time with the assistance of Mr. Cook for the two-week period, and Mr. Courtright, an officer of the OIGB, for the first week. Cook had retired after 42 years with the Canadian Imperial Bank of Commerce in various capacities. He had worked for about 30 years in Calgary.

The final report was based on a review of 173 accounts totalling $551.3M, the Dexleigh-Hees transactions, a recent credit authorization to "Blank" International Corporation and the Rondix agreement, totalling $323M. The final report encompassed loans considered during both the initial and second reviews, without indicating how many accounts were reviewed in each. It was estimated that loan losses of $49.6M would be incurred on the portfolio of $551M which was reviewed.

Loans reviewed were placed in three categories:

1. acceptable (competitive rate of interest, underlying security provides full coverage or company possesses sufficient resources to retire loans in an orderly fashion);

2. poor (deficiencies in security coverage, rate of interest below prime, or company experiencing operating losses. Principal losses

not expected; however, bank management would have to devote considerable time to avoid losses); and

3. doubtful (nonaccrual loans and loans where the security values have eroded significantly. High risk of principal loss).

Table E.8 illustrates Adamsons' conclusions.

Table E.8

Adamsons' Conclusions

	Acceptable	*Poor*	*Doubtful*	*Total*	*Provision*
			($ 000)		
Real estate	25,873	96,067	192,989	314,929	43,326
Energy	21,220	17,664	22,575	61,459	—
Manufacturing and misc.	43,250	2,240	3,695	76,185	5,980
Directors, shareholders	30,529	16,294	9,333	56,116	325
SBEC	—	42,400	—	42,400	—
Total	120,872	174,625	255,592	551,089	49,631
	22%	32%	46%	100%	9%

Adamsons' assessment of the bank's loan portfolio after this second review reflected his first examination's results, noted earlier. In addition, he commented negatively on the concentration of risk in single borrowers and the frequent lack of definition of a source of repayment.

Cook prepared a separate report. In testimony, he stated that he was very shocked by the practices he found in the bank; terms granted by the bank were largely unilateral in favour of the borrower. He criticized the bank on much the same grounds as Adamsons. He also noted that many accounts were problem loans which had been taken over from other banks without improvement in the borrower's financial status; that there were frequent instances of 100 per cent financing; that Northland had often agreed, contrary to standard banking practice, to carry term borrowing for several years with no reduction of principal; that "working capital loans" were often granted to cover a borrower's interest costs, held as a term deposit in the borrower's name and reduced as interest payments fell due, all deferring classification of the loan as bad; that in one instance, a "future performance" loan was granted despite a lack of assets, contracts, and earnings in the borrower;

and that entire loans were frequently granted on the strength of an "undertaking to provide security", again contrary to usual banking practices.

2. Curator's Review

The curator undertook a review of substantially all of the loans of the Northland Bank. This review was carried out by approximately forty Touche Ross and forty-five Royal Bank personnel. The Royal Bank personnel were senior credit and inspection officers who were instructed to review loans on the same basis as if they were examining a unit of their own organization. Loans in the various regions were assessed by regional personnel of the Royal Bank. Where practical, all findings were reviewed by the Touche Ross personnel with local management and the summary results were forwarded to the Head Office where they were consolidated to ensure consistency of approach. It is notable that branch files were reviewed, enabling Royal Bank personnel to consider the original application for the loan and the most recent statement of information on the files. The review was carried out on a liquidation or going concern basis (from the point of view of the borrower) as appropriate; that is, the reviewer employed a going-concern basis unless there was some valid reason for doing otherwise. The possibility of offsets between deposits and advances was considered. There were several loans where the amounts advanced included an amount to be set aside in a Northland term deposit, which deposit would be used to service the loan. Reviewers offset any deposit against the balance of the loan, and reduced the balance of the loan accordingly. Security was valued on a "realistic" basis, as assessed by Royal Bank officers who were familiar with the particular geographic region. Security valuation was not undertaken on a forced sale basis; rather, the valuation was described as taking a "balanced view".

Loans assessed were classified as safe, weak, doubtful or bad or any combination of these (for example, on a $3M account, $2M might be classified safe, $300,000 doubtful and $700,000 bad). The definitions of weak, doubtful and bad are:

> *Weak*: Appears to involve more than a normal degree of risk due to an unfavourable record or unsatisfactory characteristic. There exists a possibility of loss unless the account receives the careful and continued attention of management.
>
> *Doubtful*: It is probable that a loss will occur but the amount is uncertain, and not likely to be the full amount classified as doubtful.
>
> *Bad*: Reasonable to expect that all of the amount classified as bad will be written off.

On a preliminary basis, the curator found that the total of weak, doubtful and bad loans exceeded $300M. On 20 September 1985, the curator, Morrison, and one of his officers, Frank Brown, met with Fortier and Guenette to discuss the results of the review. The preliminary finding was given to management, and reference was also made to the summary prepared by the bank's internal inspector, Iain McLeod, which indicated weak, doubtful, and bad accounts in the amount of $343M. McLeod's review had been carried out over the preceding fourteen months, and it was his evidence that he gave the bank the benefit of the doubt where feasible and classified more loans in the weak and doubtful categories than the curator, who classified more in the doubtful and bad categories.

Management took away with them copies of the Royal Bank review notes (approximately 1000 customers), and prepared a rebuttal to the curator's findings, which was presented by Fortier, Guenette, and Wettstein over a period of four days commencing on 23 September 1985. The general thrust of the rebuttal was:

> ... that it is inappropriate to take a snapshot of our portfolio at one given point in time. We feel that it is not possible to properly judge the quality of the portfolio and the appropriate carrying value on the books of the bank, without measuring the progress made to date by Northland's management and staff against the business strategies employed. We feel that these factors are understood by those that really know and understand the bank, such as our auditors, our clients, third parties who have completed significant transactions with us such as Hees International, and others who are active within the difficult markets in which we have operated.

The rebuttal outlined some of the bank's improvement strategies and successes, examples of the progress which had been made in "making value" in the portfolio over a period of time. Of the $247M of loans classified by the curator as doubtful and bad, management classified as doubtful $13.2M, bad $11M, and Rondix $79.3M. (Management took the view that some loans to be transferred to Rondix should not be considered doubtful or bad if that deal closed.) The difference in the classification over the doubtful and bad categories was $143.5M. Time did not permit management to review those loans classified by the curator as weak. Management took exception to the curator's position that the review was carried out on a going-concern basis. Guenette, Senior Vice-President, Credit, stated that, in some cases, a loan was valued on the basis that the borrower was not a going concern, and in the circumstances such an evaluation would be an absurdity. Management also contended that, given that the bank was no longer a going concern because it was in curatorship, it was stretching the limits of imagination to believe that there was a "heads-up" going concern examination.

By 24 September 1985, the curator had updated its findings as follows:

Weak	$117M
Doubtful	$107.7M
Bad	$141.2M
Total	$366M

John Easton, the coordinator of the Royal Bank team, and Morrison met with the internal Chief Inspector, McLeod, on 26 September 1985. These parties reviewed those individual classifications where the curator differed with management by more than $1M. In situations where the Chief Inspector believed that the curator was too harsh, the classification was adjusted, resulting in the following revised analysis:

Weak	$114.1M
Doubtful	$98.8M
Bad	$129.5M
Total	$342.4M

Next, specific provisions were estimated by taking a range of percentages of the classified loans. The estimated range can be seen in Table E.9.

Table E.9

Range of Percentages of Classified Loans

	Loans Classified	*Low End of Range*		*High End of Range*	
Weak	$114.1M	(10%)	$11.4M	(25%)	$28.5M
Doubtful	$ 98.8M	(50%)	$49.4M	(75%)	$74.1M
Bad	$129.5M	(100%)	$129.5M	(100%)	$129.5M
Total	$342.4M		$190.3M		$232.1M

Given that the bank had an existing appropriation for contingencies account standing at $11.5M as of 31 July 1985, the curator concluded that additional provisions required would be in the range of $180M to $220M. It is apparent that even if the low end of provision required was recognized in the financial records, the existing capital and reserves including debentures outstanding would be eliminated. The curator's report also recorded a preliminary estimate of the level of actual NPLs of $325M.

Over the course of the review, a number of transactions were noted which involved bank participation in the disposal of its security, the use of newly incorporated borrower companies and the other measures already discussed in this Appendix. As described elsewhere, a number of large exposures exceeded 20 per cent of the bank's capital.

As of 1 October 1985, there were outstanding loans aggregating $7.4M to six directors and $2.1M to thirteen senior bank officers and two executives of Epicon. Of the officers' loans, $648,000 was in relation to a share purchase plan in November 1983. The curator stated that several officers indicated to him that such shares were acquired under pressure, but senior management denies that pressure was applied. Senior management contended that Northland's policy in relation to loans to its directors did not vary from industry practice, that the ultimate test was always the borrower's ability to pay, and that the provisions of the *Bank Act* were adhered to. The musical chair rotation of directors' moving and seconding resolutions authorizing such loans (discussed in Chapter 5) leaves an impression of literal but not substantial compliance with the *Bank Act*.

In those loans where the security was real estate, it was found that many files contained inadequate or out-dated appraisals. Apart from that, the Royal Bank team found that the files were satisfactory. Finally, the curator noted that during the 1984 fiscal year, and 1985 to date, fee and other income had become a significant contribution to the earnings of the bank. "Other income" for the nine months ending 31 July 1985 stood at $8.0M, and for fiscal year 1984, was $8.1M. All fees exceeding $50,000 booked in the 1985 fiscal year were identified by the curator. They totalled $10.721M, of which $5.420M was not recognized by the end of the third quarter of 1985. There were examples where fee income exceeded 10 per cent of the amount of the loan. Easton, the Vice-President, Credit Audit and Corporate Audit of the Royal Bank, stated that the usual commitment or negotiation fees in the Royal Bank amount to ¼ of 1 per cent or ½ of 1 per cent. It is, however, fair to note that the Royal Bank has a merchant banking division about which Easton knew little.

The liquidator, in his testimony before the Commission, was asked how the loans got into a state requiring provisions ranging from $190M or more. On this he deferred to Easton, who made the following comments:

1. Northland represented itself as being able to do deals that others could not do in a market which was extremely competitive. In his opinion, if one takes on transactions which others will not, one must get a larger share of bad loans.
2. Just as the Royal Bank suffered very heavily in the western recession, unquestionably Northland suffered from that as well, more particularly because of the geographic distribution of their portfolio with heavy representation in Alberta and B.C.
3. Too many instances of 100 per cent financing. The lending policy was generous and overly aggressive.
4. The size of the fees taken in the bank are unusual.
5. There were a large number of cases where the bank seemed to have been faced with a loss but did not take it; instead, more money was put up. These loans may work out, but the risks seem extremely high.

3. Internal Inspectors

While it was not a function of the internal inspectors of the Northland Bank to assign provisions to the loans, it was their practice to classify loans. In their testimony before the Commission, their classifications have been collected, and comments were solicited from them regarding lending practices at the bank.

Stan J.C. Willy became Chief Inspector of the bank in February 1983, a position he held until August 1983. During his tenure, he assessed the bank's branches in Vancouver, Prince George, Edmonton and Calgary. Loans were graded on a scale from one to five, defined as:

1. Good;
2. Minor deterioration (documentation not finalized, other questionable matters);
3. Major deterioration (fairly clear evidence that security value was deteriorating, or repayments were not being received as agreed);
4. Nonproductive (clearly a problem; should no longer be accruing interest); and
5. Unsatisfactory (all possibilities to realize on security are exhausted, or collection procedure is in process. There is still a possibility of getting some return, but it is becoming more remote. These loans are good candidates for a loss provision).

On 8 July 1983, Willy sent a memo to the policy committee of the bank to the effect that the profile presented by the loan classification reports, representing management's assessment of the quality profile of the bank's loan portfolio, was significantly different from that drawn by the Inspector's assessment of the loans. Neapole, a member of the policy committee, denied ever receiving this report, since it was not the custom of the policy committee to receive handwritten reports from its Chief

Inspector. In any event, Willy's report is indicative of his differences in relation to management loan quality assessment.

The loan portfolio profile shown by management records as of 31 May 1983 is shown in Table E.10.

In comparison, Table E.11 outlines the inspection grade assessment for the comparable dates. The Chief Inspector suggested that in his view, as of July 1983, approximately $175M, or 30 per cent of the bank's portfolio, could be regarded as essentially nonproductive or worse (that is, Class 4 and 5), whereas at 31 May 1983 the bank reported approximately $61M in nonproductive loans.

In order to put the above findings in perspective, it is necessary to note that Willy testified that, in the case of all his assessments, there was concurrence by each regional manager of the respective branch. It is also necessary to note that while Willy had no previous experience as an inspector (and indeed, his previous experience is not on the credit side of a bank), as of 26 April 1983, it had never been suggested to him that he lacked the necessary skill or ability to act as Chief Inspector. Willson was, on the contrary, quite complimentary about Willy's Vancouver reports. Willy testified that the practice of capitalizing interest appeared widespread, and that he felt it was happening far too frequently. He also said that it was common practice to charge a fee, and to provide for its payment in the overall loan amount.

The other Chief Inspector who gave evidence is Iain McLeod, who has held various positions on the credit side of banking, the most recent of which, before joining Northland in 1983, were in the Royal Bank. The results of McLeod's inspections, carried out over a 14-month period are summarized in Table E.12.

As can be seen from Table E.12, and from earlier discussion in this Appendix, there is little difference between the total amounts classified by the curator and McLeod. However, there is a large variation in the allocation within the categories of weak, doubtful, and bad. Several reasons are apparent. First, McLeod's inspections took place over a 14-month period, whereas the curator's inspection lasted just one month. Second, it was the evidence of the Chief Inspector that he gave management the benefit of the doubt in his assessment of accounts. If the Chief Inspector was wrong, he could make corrections in the following year.

The Chief Inspector testified that the provisions established by the bank were insufficient. McLeod commented on the lending practices of the bank which were much the same as the comments of Adamsons and Cook:

Table E.10

Loan Classification (Management Records) ($M)

	One		*Two*		*Three*		*Four*		*Five*	
Branch	**$**	**%**	**$**	**%**	**$**	**%**	**$**	**%**	**$**	**%**
Saskatoon	20.1	71.5	4.7	16.7	3.3	11.7	0.8	2.8	9.0	0
Winnipeg	30.9	56.7	6.9	12.7	3.4	6.2	0.9	1.6	13.2	24.2
Vancouver	21.5	24.7	5.2	6.0	38.8	44.6	4.1	4.7	17.3	19.9
Prince George	13.9	21.9	17.1	26.9	24.3	38.3	7.6	11.8	0.7	1.1
Edmonton	67.0	51.6	10.1	7.8	34.8	26.8	15.0	11.8	2.9	2.2
Calgary	82.3	55.9	18.8	12.8	32.5	22.1	8.2	5.6	5.5	3.7
Corp. lending	58.8	63.1	5.6	6.0	7.9	8.5	20.9	22.4	0	0
Total	294.5	48.8	68.4	11.3	145.0	24.0	57.4	9.5	39.6	6.6

Table E.11

Loan Classification (Inspection Grade Assessment) ($M)

	One		*Two*		*Three*		*Four*		*Five*	
Branch	**$**	**%**	**$**	**%**	**$**	**%**	**$**	**%**	**$**	**%**
Saskatoon	20.1	71.5	4.7	16.7	3.3	11.7	0.8	2.6	0	0
Winnipeg	30.9	56.7	6.9	12.7	3.4	6.2	0.9	1.6	13.2	24.2
Vancouver	6.8	9.4	15.6	21.4	15.2	21.0	5.5	7.6	24.7	35.9
Prince George	4.8	7.9	16.4	27.1	18.0	29.6	16.8	27.6	4.7	1.8
Edmonton	18.0	14.0	26.8	20.8	44.7	34.6	5.9	4.6	33.5	26.0
Calgary	20.4	13.9	39.1	26.6	37.5	25.5	20.8	14.1	29.3	19.9
Corp. lending	58.8	63.1	5.6	6.0	7.9	8.5	20.9	22.4	0	0
Total	159.8	27.6	115.1	19.0	130.0	22.5	71.6	12.4	105.1	18.2

Table E.12

Loan Classification (McLeod)($000's)

Branch	*Date of Inspection*	*Classification*						*Total Classified*	
		Weak		*Doubtful*		*Bad*			
Calgary	April 1985	78,694	29.5%	27,065	10.1%	3,060	1.2%	108,820	40.8%
Edmonton	April 1984	26,925	18.4%	11,133	7.6%	28,508	19.5%	66,566	45.5%
Prince George	June 1984	11,473	16.1%	10,380	14.5%	12,433	17.4%	34,286	48.0%
Toronto	November 1984	385	0.8%	4,008	8.3%	30	0.06%	4,423	9.1%
Vancouver	January 1985	17,144	19.6%	18,172	20.7%	5,249	6.0%	40,564	46.3%
Winnipeg	July 1984	2,350	3.9%	2,149	3.6%	103	0.1%	4,602	7.6%
Saskatoon	June 1985	12,711	24.9%	10,182	19.9%	3,294	6.5%	26,187	51.3%
Energy	July 1985	55,606	45.5%	647	0.5%	1,694	1.4%	57,947	47.4%
Total		205,288		83,736		54,371		343,395	

1. Excessive restructuring of loans;
2. Capitalization of interest plus provision of additional funds for future interest;
3. Sale of poor performing assets at book value, often 100 per cent financed by the bank at book value plus debt servicing;
4. Heavy concentration to a few borrowers for large amounts, in relation to the capital of the bank;
5. Speculative real estate transactions based on future events. If these events did not occur, repayment of the loans would be extremely difficult;
6. Rampant portfolio expansion at the time when other banks were retrenching;
7. Stubborn refusal to admit, recognize, or be financially able to make appropriate provisions for losses; and
8. In many instances, the granting of loans was fee-driven.

McLeod pointed out in his testimony that initially, if part of a loan was potentially classifiable, the entire amount of the loan was classified (the "two-by-four approach") to get management attention. Later, the procedure changed, and parts of loans could be classified in different categories. The inspection of the Vancouver branch of 14 November 1983 was carried out on the old basis, but apparently none of the others were. The Vancouver inspection results for 14 November 1983 are not included in the table of the inspection results. It is also fair to note that the above-mentioned lending practices in the bank mostly arose from the treatment of problem files, where the alternative was simply to write the loan off.

I. CESSATION OF OPERATIONS

On 28 August 1985, the Minister of State (Finance), one of her staff, the Inspector General, and the Minister's counsel met with Willson and Fortier. The Minister stated that at this point she had not finally decided on the course of action to be followed. The Inspector General, on the other hand, was of the view that the bank should be closed. Northland officials first briefed the government on various attempts to find a solution for the bank. Management had met with the Banking Committee of the Alberta Cabinet to request that the province guarantee Northland's commercial paper, invest in equity, and assist Northland in discussions with an international bank to pursue the object of converting Northland into a Schedule B foreign bank. In addition, discussions had been held with the Finance Minister of the Government of Saskatchewan to request an increase in Government of Saskatchewan deposits. Northland had also been in contact with the Hees company with the object of securing an agreement whereby Hees would "stamp" $250M of Northland's commercial paper, or guarantee it. A discussion developed as to whether Northland could survive a CCB insolvency. It was the view of the Minister that some solution would have to be developed for Northland before CCB was closed. The Minister was not persuaded by the potential solutions put forth by Northland because the bank could not produce any firm proposals. Subsequently, the Minister met with Allan Taylor of the Royal Bank to request that he canvass the Schedule A banks to determine whether one of them would be willing to merge with Northland Bank. None of the banks were interested.

The possibility of arranging a support package for Northland was rejected at this time. In a memorandum of 29 August 1985, the Deputy Minister of Finance advised the Ministers that a support package might be expected to cost upwards of $250M. It was also estimated that losses on realization could prove substantially larger than $300M. This would generally accord with information which the Minister had received from the National Bank review and from the OIGB.

The Ministers learned on 31 August 1985, that the Government of Alberta was unwilling to assist Northland as fully as the bank had hoped. At best, Alberta was willing to convert a $70M deposit into some other form of financing.

On 31 August 1985, the government was "pretty convinced" that a curator should be appointed, but desired one last meeting with management. Willson, Scarth, Neapole, Fortier, and Gordon proceeded to Ottawa and met with both Ministers, their counsel, and one of their staff. The bank was advised that CCB would be closed, and a discussion ensued about what would happen to Northland. Management felt that no curator should be appointed. While Northland would suffer in the short run upon the closing of CCB, it would, they thought, benefit in the long term because, finally, Northland would be seen as being different from CCB. This opinion was not accepted as plausible. When the meeting broke up, the government side met with the Inspector General and the Assistant Inspector General to discuss Adamsons' final report on the loan portfolio and the results of the National Bank review. The bank was then advised that the appointment of a curator would protect it from the negative effects of the CCB closure, and that the decision had been taken because the government had in its possession a report which indicated that no solution was possible. That report was the Adamsons report. Management were not given the opportunity to review it or respond to it. Hence, they were restricted to the assertion that, whatever was in that report, it would probably be embraced by Rondix. The Minister of State (Finance) did not view Rondix as a solution to the bank's problem; it was a bad deal. The meeting was adjourned to enable Northland officers to communicate with their

Board of Directors. In the course of a further meeting on 1 September 1985, the Ministers were advised that the Board would not acquiesce in the appointment of a curator. Northland believed that the assets of the bank would be better preserved by bank management in association with its auditors. The current drain on Northland's deposits was attributed to CCB's problems and, accordingly, the Bank of Canada funding facility, having been designed to protect banks against market influences of this kind, should continue to be available.

The provisions of s.278 of the *Bank Act* authorizing the Minister to appoint a curator specify certain preconditions in terms of the financial position of the bank in question. In particular, the Minister's authority to appoint a curator under s.278(2) is dependent on the opinion of the Inspector General that "a bank will not be able to pay its liabilities as they accrue".

On 1 September 1985, as in the case of CCB, the Governor of the Bank of Canada was informed by the Inspector General that the bank was no longer "viable". In the result, the Bank of Canada ceased funding the Northland Bank, so that it was unable to meet its liabilities as they came due. The Inspector General then reported to the Minister that the condition specified by s.278(2) existed. The OIGB had strong suspicions, but was not then in a position to demonstrate, that the bank was also insolvent in the sense that its liabilities exceeded its assets.

On 1 September 1985, a curator was appointed. A press release stated, in part, that the Ministers were prepared to accommodate the belief of the bank's Board of Directors that Northland's business might be preserved through reorganization or amalgamation. Consequently, it was agreed that the bank would be given limited time to seek to reorganize its affairs or amalgamate with another financial institution.

In order to assist Northland Bank in reorganizing its affairs, the government appointed Mr. R.E. Bellamy, an investment dealer, to evaluate proposals on behalf of the Minister, and to advise on their viability. Bellamy had, as of 23 September 1983, received and reviewed three written proposals for restructuring Northland's finances, and was aware of one other representation made by a major bank shareholder. The three written proposals shared certain common features, including participation by both the federal and Alberta governments, and the raising of additional capital for the bank. Bellamy concluded that "for confidence in the Bank to be restored it must be aligned with an institution or institutions of unquestioned financial strength, and market credibility". Major flaws were seen in all of the proposals. Bellamy conducted discussions with certain major international bankers presently operating as Schedule B banks in Canada, and concluded that the terms of any takeover of the bank's business operations would require a commitment by the government to cover losses on the loan portfolio. In the circumstances, it was concluded that such a commitment was not acceptable. Liquidation followed in early 1986.

Appendix F

Banking Practice and Auditing

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Appendix F

Banking Practice and Auditing

A. GENERAL AUDIT FUNCTIONS

1. Overview

The operations of an enterprise are under the control of management, which has the responsibility for the accurate recording of transactions and the preparation of financial statements in accordance with appropriate accounting policies. These responsibilities include designing and maintaining accounting records and internal controls, selecting and applying accounting policies, safeguarding assets and preventing and detecting fraud and error.

The purpose of an audit is to express an opinion as to whether the financial statements prepared by management fairly present the financial position of the bank at the specified date, and the results of operations for the period under review in accordance with generally accepted accounting principles (GAAP) as modified and extended by the *Bank Act*. Within GAAP are requirements that speak to the need for judgment. GAAP include a requirement that where the application of any particular recommendation of GAAP would give an unfair result, professional judgment should be exercised to the extent required to avoid such a result.

The auditors of a bank are subject, beyond their normal professional duties and principles, to the additional strictures of the ***Bank Act***. Under the Act, bank auditors have at least one more constituent, the Inspector General (and through him, the Minister of Finance), than auditors generally have. It might also be said that bank auditors have one other constituent. A bank auditor has no statutory or contractual link with the depositors, but their presence, and the nature of their claim in law on the bank (and sometimes against the auditors as well!) must be in the constant contemplation of the auditors. The auditor's decision to approve a bank's financial statement may affect the bank's stability, because of a bank's considerable exposure to the obligation to repay the deposits. The balance is frequently delicate and any tremors, though minor in another corporation, may in a bank set off a domino reaction with grave consequences.

The CICA Handbook states that the auditor's opinion is neither an assurance as to the future viability of an enterprise, nor an opinion as to the efficiency or effectiveness with which its operations have been conducted. The level of assurance provided is reasonable assurance that the financial statements taken as a whole are not materially misstated. Auditing procedures are designed on the assumption of management's good faith, and auditors exercise professional judgment regarding the extent to which they will rely on management systems. Absolute assurance is not obtainable because of the need for judgment, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

The concept of professional judgment embraces a number of principles which will now be discussed.

a. Objectivity

The audit examination must be performed by persons with an objective state of mind, free of any influence, interest or relationship in respect to the client's affairs which could impair their professional judgment.

b. Audit Evidence

Generally accepted auditing standards require the auditor, through his examination, to obtain sufficient and appropriate audit evidence to provide a reasonable basis for the opinion. Complete verification of every transaction is neither contemplated nor practicable. Instead, audit evidence is obtained by carrying out compliance and substantive procedures. Compliance procedures are designed to assure that prescribed internal controls are operating effectively. The degree of reliance that an auditor places on internal controls influences the extent of his substantive testing. Substantive procedures provide direct evidence as to the validity of the data produced by the accounting system. The exercise of professional judgment is involved at both stages in determining the scope of the examination and what constitutes sufficient and appropriate evidence as the basis for the auditor's opinion.

c. *Materiality*

Materiality, in the context of an auditor's decision making, refers to the quality of a statement or misstatement of a matter of accounting information in relation to the overall condition of the institution under examination. The general test was well stated by Dilworth and Broadhurst. The former stated that:

> ... materiality is a question as to whether or not the degree of error or the degree of potential error would affect the judgment of a reasonable person and influence his decision as a result of the information that he was reading.

Broadhurst on the same point stated:

> In addition to the various mechanical tests, such as percentage of normalized profit, percentage of total loan portfolio, or some other measure I would like to ask myself one further question, and that is: If the adjustment that I am after was booked, is there a good chance that the readers of the financial statement would take away a message, after the adjustment, which would be different from the message that they would have from the financial statement without the adjustment and, as a result, take a different course of action? This is also subjective.

Decisions as to materiality may, according to Dilworth, be affected by the condition or stability of an enterprise; as it gets into difficulty, materiality will have finer limits. In accordance with common sense, the nearer the precipice, the more the investor and depositor will want to know and the less room for error.

d. *Going Concern*

A fundamental initial assumption underlying the preparation of financial statements in accordance with GAAP is that the audited enterprise is a "going concern"; that is, that it will be able to realize assets and discharge liabilities in the normal course of business for the foreseeable future. One responsibility of the auditor is to satisfy himself that there is evidence to support this assumption. Conditions which may cast doubt on the ability of the enterprise to continue as a going concern include recurring losses from operations or serious deficiencies in working capital, inability to obtain financing sufficient to ensure continued operation, inability to comply with terms of existing loan agreements, the possibility of an adverse outcome of one or more contingencies, insufficient funds to meet liabilities, plans to curtail significantly or liquidate operations, and external factors that could force an otherwise solvent enterprise to cease operations. The auditor must make an assessment of the circumstances in each case to determine the extent to which the existence of such conditions may affect the enterprise's ability to realize the carried value of its assets and to continue as a going concern. If it is concluded that they pose a serious threat to the enterprise, disclosure must be made in the statements, or the auditor must qualify his opinion. It should be noted that the evidence needed to justify qualification of the financial statements in this way is good hard evidence raising very serious doubts. In any case, however, where there is uncertainty as to the likelihood of continuation, more conservative accounting principles should be used; for example, a shorter period for the valuation of assets, closer to realizable and liquidation values. As always, the auditor's responsibility is to review and assess the accounting treatment, disclosure and presentation to ensure fair presentation in accordance with GAAP.

The presumption that the enterprise is a going concern is consistent with the contention that the auditor's opinion is not an assurance of its future viability, on the basis that financial statements are drawn to present a picture of the enterprise at a particular point in its life.

2. Application of GAAP

There is no great departure from generally accepted accounting principles in relation to bank audits, although the CICA Handbook states:

> Handbook recommendations are intended to apply to all types of profit oriented enterprises. ... However, pending further study, the recommendations do not necessarily apply to the special problems of banks and insurance companies. No recommendation is intended to override the requirements of a governing statute.

The Audit Standards Committee of the CICA proposed in May 1985 that this exemption should be removed, reflecting the adoption and practice by members of the CICA of GAAP and other related Handbook recommendations as the framework for auditing banks. The OIGB expects banks to adhere to GAAP, at least in relation to the preparation of the Schedule J balance sheet prescribed by the *Bank Act*.

However, certain limited departures from GAAP are prescribed by the *Bank Act*. First, the form and content of bank financial statements are contained in the Act. Second, bank accounting principles depart from conventional accounting principles in the method of accounting for loan losses, the method of accounting for gains and losses on the disposal of certain debt securities, and the method of translating foreign currency transactions and financial statements.

The method of accounting for loan losses is the most fundamental of these differences. Loss adjustments (specific reserves) made to the loan accounts are charged to the "appropriations for contingencies" account reflected in the capital and reserve section of the balance sheet. The annual loan loss provision based on the five-year historical loan loss experience expressed as a percentage of the loans outstanding and applied to the year end balance of loans is credited to "appropriation for contingencies" and charged to the statement of income. The rationale for this smoothing effect is supposed to be the confidence factor in banking. This account assumed some prominence in the evidence concerning CCB.

3. Significant Bank Accounting Principles

a. Capitalization of Interest

Capitalization of interest refers to the advance of money by the bank to the borrower to enable him to pay the interest on his loan from the bank. Interest may be capitalized pursuant to the original loan agreement, or on an unplanned basis. Capitalization is planned where the bank and customer do not expect a revenue stream sufficient to service the loan to develop immediately. The most common example is the real estate development loan. It is a common and acceptable practice to include in such loan contracts provision for funds sufficient to pay interest during a defined operating period. Unplanned capitalization of interest, on the other hand, is considered to be a warning signal, because it indicates the borrower's inability to meet its loan obligations, perhaps in the long term.

Broadhurst testified that because interest capitalization, in some instances, is a decision to advance additional funds to the borrower, the decision to capitalize interest should be made on the same considerations as the original loan. In short, he said that a new credit assessment of the borrower should be made. The Assistant Inspector General expressed a less conservative test when he took the position that there is nothing wrong with capitalization of interest up to the value of the security, as long as this value is certain. The auditors of CCB, Lord and Carr, were of the view that the capitalization of interest on a loan restructuring is permissible where there is reasonable assurance about ultimate collectability of the loan. In contrast, Korthals said:

> ... when we restructure we want to make sure that our claim on the restructured company represents ... original principal plus unpaid interest, but we would never try and capitalize that in a way that we would recognize that as income. It would only be income when indeed we got paid cash.

Management of both CCB and Northland Bank have testified that their practices with respect to capitalizing interest were no different than the practices in other banks. As a result, the practice of the other banks was the subject of much discussion at the hearings. McLaughlan stated that capitalization would sometimes occur in a full service bank in another form, when cheques in payment of interest or fees to the bank overdraw a current account, triggering an operating line of credit. Since CCB did not offer a current account service for its customers, it simply tacked the interest on to the loan principal balance where collateral values covered the full amount. Neapole said it was common practice in his experience to debit and consider collected interest due to operating accounts. Korthals, in discussing this matter, was unsure whether such a debit to an operating account could be characterized as capitalization of interest and said that, in any event, this would not continue in a default situation. As CCB and Northland often capitalized interest on workouts after default, the McLaughlan and Neapole contention that the practices are equivalent is not valid.

The Toronto-Dominion Bank does not capitalize interest in restructuring a loan. When a loan is not in default, the bank will often lend money and pay interest to a borrower who is profitable and healthy. Thus the bank loan may grow every year, and in that sense the bank is capitalizing interest. If the company experiences a downturn, the bank may terminate such an arrangement. This position is summarized in the response of the Toronto-Dominion's General Manager and Chief Accountant, dated 12 March 1984, to an OIGB survey:

> It is normal practice to charge interest to loan principal or to create/increase an overdraft for the amount of the interest where the overall liability of the borrower is either within the authorized line of credit or is well secured. In such cases, the loan would be considered current and therefore should not be reported. ...

Mulholland, the Chairman and CEO of the Bank of Montreal, testified that the capitalizing of interest at that bank is forbidden, except in a "tiny chink" of cases, "one of which would be construction project loans". Interest may not be capitalized if the loan has been placed on a nonaccrual basis, or where capitalization would avoid placement of the loan on a nonaccrual basis.

Fullerton, the Chairman, President and CEO of the Canadian Imperial Bank of Commerce testified that at his bank, interest is never capitalized if the loan is in default, and that if management is uncomfortable with the loan, it would not be maintained as current by adding interest to principal. If the borrower is in default and desires a further advance as part of a restructuring, the further advance goes through the full loan application process. A letter from the Vice-

President and Chief Accountant of the bank, dated 14 March 1984, and written in response to the OIGB survey above mentioned, states the CIBC position:

> ... It is normal bank practice to permit the charging of interest to loan principal or an overdrawn account where the overall liability of the borrower is within an established line of credit or considered to be collectable. Under such circumstances the interest is considered to be paid. Furthermore, if there has been activity in the borrower's accounts how can it be said that the interest has not been paid?
>
> We would also point out that the proposed new guidelines will effectively control bank practice in this respect. If, perchance, a problem loan account is involved, the bank would of necessity be assessing the overall risk and past due interest would not be capitalized if collection of the enlarged principal outstanding was at risk; the loan would be placed on a non accrual basis.

At the Royal Bank of Canada, apart from those cases where the capitalization of interest is part of the original contract or arrangement, the rule is:

> Other exceptions may arise especially where it is clearly evident that our funds are safe and it is in the bank's interest to accommodate the claim. However, such situations must be supported by sound judgment and submitted for consideration on a case-by-case basis to the respective headquarters or head office as the case may be.

Capitalizing of interest is undertaken only where senior management is absolutely certain that the bank will recover all its money. This decision is made by a member of senior management who was not involved with the particular loan. However, stated Allan Taylor, it would not be usual for the bank to continue capitalization year after year because to do so would "distort ... overall accounting records."

Ritchie, Chairman and CEO of the Bank of Nova Scotia, testified that interest is very rarely capitalized on a nonaccrual loan. If the loan is classified as nonperforming, capitalization of interest would be unusual, especially in workout situations. However, the key is the underlying security value.

Bélanger testified that it is a policy of National Bank that borrowers must pay the interest and principal with their own funds in the normal course of business. Interest is not capitalized, except in some project loans.

It would appear from the above review that there are three practices regarding the capitalization of interest: (1) capitalization forbidden; (2) capitalization permitted on the basis of a new credit application, judged according to the bank's normal lending criteria; and

(3) capitalization permitted up to current market value of the security. The acceptability of the third practice is relevant to the Commission's mandate only in the context of the accuracy of the financial statements which were relied upon, rightly or wrongly, by the OIGB. Consideration of this matter is postponed until other banking practices are outlined, but it may be noted here, for reasons that are developed later, that the third practice is imprudent. MacKenzie testified that, at the very least, one should have a generally higher quality of security and collateral coverage when employing the third practice.

Some capitalization of interest may be acceptable to the auditors and justified from the point of view of the bank. In the unplanned capitalization case, the auditor should, according to Broadhurst, seek evidence of a further assessment of the overall loan situation to determine whether it is appropriate to advance further funds to be used for the payment of interest. Again according to Broadhurst, if there is *any* doubt about collection, interest should not be capitalized. Where interest is properly capitalized, it is his view that the practice does not artificially inflate the financial statements.

b. Accrual of Interest

Rules regarding the accrual of interest are now standardized in the OIGB Non Performing Loan Paper of June 1984, which applies to the 1985 and following fiscal years. However, CCB and Northland Bank did not finish fiscal 1985. Prior to 1985, absolute uniformity did not exist among Schedule A banks in relation to interest accrual, and there was no industry consensus on the subject. A common thread was that where interest was past due for a specified number of days, accrual ceased. For example, at the Toronto-Dominion Bank, any loan where interest was contractually past due 90 days was classified nonaccrual, unless the loan was insured or guaranteed by a Canadian government. Other loans which were not yet in arrears could be classified as nonaccrual where in management's opinion there was doubt about the ultimate collectability of any portion of the principal or interest. Once classed as nonaccrual, any interest accrued on the loan was reversed. There was no management override.

Other banks had a management override. The stated policy at the Royal Bank was to discontinue accrual of interest when payment was past due 90 days, or sooner if collectability was in doubt. In 1983, the note to the Financial Statement was changed to provide:

> Loans are placed on a nonaccrual basis ... when payment of interest is 90 days past due unless management determines that the collectability of principal and interest is not reasonably in doubt.

This change in wording was made for clarification only; the Royal Bank did not thereby become less conservative. The bank had always made rare exceptions to the 90-day rule where, notwithstanding that interest was past due more than 90 days, the valuation of the security was such that it clearly exceeded the amount of principal and interest owing. The rarity of this case is illustrated by the fact that, since 1 November 1984, the Royal Bank has had only one loan in excess of $4M for which interest continued to be accrued beyond 90 days. This loan was subsequently placed on a nonaccrual basis and all accrued interest was reversed.

Some banks reversed the interest on loans which had been determined to be nonaccrual during the current period. One bank ceased to accrue interest on loans 90 days past due, but did not reverse it until interest was overdue for 180 days. Some banks made exceptions to their general rules based upon a specific assessment of the account, including the underlying value of the security. Other banks would not admit to such exceptions. The divergence in accounting policies is illustrated by the practice of one bank, which reversed current year interest against income on nonproductive loans, but capitalized interest related to prior fiscal periods and considered such capitalized interest in the determination of loan loss provisions. Rarely would a bank continue to accrue interest past 90 days or 180 days, as the case may be, based on a specific management override. Mulholland said:

> ... we polled the operating groups to find anybody who could remember using the management override. We have been unsuccessful in finding anybody that had used it or can recall using it.

Starting in 1983, and culminating with the Inspector General's Non Performing Loan Paper of June 1984, several banks adopted policies in compliance with the rule that loans should be placed on a nonaccrual basis payment if interest is 90 days past due unless management determines that the collectability of principal and interest is not reasonably in doubt. The reasonable doubt qualification is known as the "management override". The degree to which the management override is used appears to vary among the banks. The bankers were agreed that use of the override is viewed as exceptional. Most of the banks regard it as rare.

The auditor, according to Mackenzie, reviews management's decision as to the accrual of interest according to the following factors quoted from a memorandum he authored on the subject:

> 1. Underlying security values were more than adequate to cover principal and interest.

2. There is a realistic probability that the borrower will in the reasonably near future be able to generate adequate cash flow to service the loan and that interest accruals whether capitalized or not are covered by collateral with present market values adequate to cover the interest. In other words, while it may be sufficient to value collateral related to principal amounts in a longer time frame in arriving at judgments as to the collectability of principal, the collateral security covering loans where interest is being accrued should be of good quality in terms of present market value. This is based on the general proposition that performing commercial loans could, if need arises, be sold on a nonrecourse basis to other leaders [sic: lenders] at their carrying value including accrued or capitalized interest.
3. The safety of the loan, including interest, should not depend on third party guarantees unless those guarantees are undoubted (e.g. a government guarantee or one from a corporation with a first class credit rating) or are themselves supported by good quality collateral.
4. Unpaid interest is not being booked on loans related to dormant projects such as vacant land where there is no active current sales program which is producing results or is reasonably likely to do so.
5. Where an unsatisfactory loan situation exists, there are refinancing, restructuring or other reorganizations in place (or almost certainly to be put in place) which will result in either:
    - (i) providing in the near future cash flows adequate to service the loan, or
    - (ii) additional good quality collateral is being put up to justify the capitalization of interest.
6. The Bank (or other creditors) have not put in and is not intending to put in a receiver to manage the affairs of the debtor.

c. *Loan Loss Provisions*

Practices regarding loan loss provisioning affect the carrying value of the loans as stated in the financial statements and income as reported in the income statement. Both CCB and Northland were, during the recession in Western Canada, faced with dramatic decline in the market value of assets taken as security for loans. The banks regarded this as an abnormal situation, and accordingly, they developed policies to deal with it. Instead of valuing assets held as collateral on a current market basis, the CCB considered that a more realistic value could be established by taking into account an expected recovery in the market from one to three years hence ("baseline value"). In Northland Bank's case, a "workout strategy" for the bank was devised which involved the establishment of specific plans to workout hard assets which had been acquired as a result of realizing on soft loans. Such assets, in the workout stage, were valued on a basis known as "investment value". Apart from terminology, the CCB and Northland schemes were essentially the same. Both overlooked the present market and attracted value to the assets by reason of assumed or hoped for improvement in market conditions in the undefined future. The propriety of the baseline value and investment value concepts are considered in some detail elsewhere; it is sufficient here to describe the attitude of the large banks toward them.

All of the CEOs and Presidents of the large banks who gave evidence on this subject disapproved of CCB's baseline values. One banker testified that the value, if there are no buyers, is "zero". Some of the bankers testified that where the value of the security has eroded due to economic conditions, the bank should take a rolling assessment, adjusting the provision as the value deteriorated. Taylor said:

> I would just add ... looking at that type of example where you talk about placing perhaps a zero value on a property where there is nobody out there, obviously, in the market prepared to buy, I do not know of any lenders who walk away from properties under those circumstances. That tells me that there is some ongoing value. ...

Expert auditing evidence also approved the use of such a rolling assessment. Broadhurst stated:

> When we are valuing security and our economy is on a down trend ... it would not be unusual to see a provision against a loan increase in successive years. ...
>
> ... similarly, it is not unusual to have made a specific provision ... to have the fortunes of that company or the economy improve, in which case, some or all of that provision will be reversed in a subsequent year. ...

Most of the bankers said that in determining whether there should be a provision, there are two issues; the ability of the borrower to pay, and the value of the security. If the borrower is a going concern, the value of the security is not immediately important. Where doubt arises as to the ability of the borrower to pay, or where the bank is supplying the ability to pay by advancing funds for this purpose, then the value of the security becomes a material consideration.

All of the bankers emphasized the judgmental nature of provisioning. Standards in this area, like most other accounting areas in banking, vary from bank to bank. Some bankers provision for "possible" losses, while others provision for "probable" or "likely" losses. The latter is an acceptable practice.

Only one bank, the Canadian Imperial Bank of Commerce, has written guidelines on this subject. The general rule is as follows:

> It is expected that you will apply conservative, objective, and realistic judgment to arrive at the proper estimate of the possible loss or estimated loss in each account.

The policy goes on to state:

> A specific provision should normally be established when there is reasonable doubt as to recovery and the outcome is dependent upon factors that cannot be forecast with reasonable assurance.
>
> Specific provisions should not be made to the extent of:
>
> (a) a conservative value of tangible security, or
>
> (b) a reasonable but conservative estimate of the amount collectable from assigned receivables or merchandise, collateral paper, endorsements, guarantees, or other similar security
>
> (c) if mortgage security is held, a conservative estimate — usually supported by a reliable appraisal — of the net amount recoverable,
>
> (d) a conservative estimate of the amount collectable from other sources including, on a highly selective basis, future income.

The Toronto-Dominion Bank employed a wholly different approach. Finding it very difficult to assess accurately the value of collateral, and in view of the low number of nonaccrual loans in the bank, the bank decided that the best way to reflect the financial position was to cease to accrue interest rather than to establish a loss provision, since nonrecognition of interest produces a far greater impact on the profit and loss statement for the year. This is true so long as the present rule providing for a five-year rolling average for loss provisions continues. By 1983, the bank had nonaccrual loans on the books for more than one year without any action having been taken. This had never happened before. In 1984, the bank wrote down all such nonaccrual loans by a minimum set percentage (25 per cent in Alberta and 10 per cent in British Columbia, with an increase in 1985 if circumstances did not change). This sectoral provision was applied only to nonaccrual loans in the sector, not to all loans, and was considered a minimum appropriation.

In addition to the evidence of the Presidents and CEOs of the large banks, the Commission heard evidence about provisioning from line bankers. Line bankers with credit experience in Alberta who had the opportunity to inspect CCB files testified that they had never seen baseline values used before. Tallman described the practice as unreasonable and unrealistic.

Broadhurst, asked for his opinion regarding security valuation methods, stated that he would be "concerned" with starting from an assumption that economic circumstances would improve significantly, and would examine each loan file to determine the degree of improvement expected and the reasons for the improvement. He said that "conservative valuations are the order of the day". The auditor should not completely ignore economic factors in trying to arrive at some reasonable valuation in a situation where the market for the underlying security is seriously depressed, as long as the judgment is reasonable when viewed both at the level of the individual loan and at the global level of the bank's loan portfolio. The auditor must exercise caution here; if very optimistic economic assumptions are widespread, the auditor must be "very significantly on guard" because such assumptions are dangerous. Broadhurst would be "alarmed" at this method of valuation.

d. Workouts and Loan Loss Provisions

It is standard banking practice in Canada to consider working out a problem loan; to write off a loan is a last resort. Workouts may involve a rescheduling of principal and interest, the conversion of debt into equity, or the granting of further loans to enable the debtor to work its way out of difficulty. In considering whether to restructure a loan, or to establish a specific provision, the bank considers the borrower's balance sheet and earnings record, the calibre of its management, the value of the security, and other relevant circumstances. Specific provisions on loans are also made with due consideration of the economic outlook, but less emphasis is placed on that.

It is important to distinguish the operational decision to work out a loan from the accounting consequences. The operational decision to work out a loan does not obviate the necessity of taking a provision where one would otherwise be required. MacGirr said, and Broadhurst agreed, that:

> ... an election to wait on the disposal of the underlying security in my opinion, should not affect the setting up of appropriate provisions. If it were otherwise — I guess it is obvious — the bank could escape setting up any provisions by simply electing to hang on to all of its bad loans.

A provision need not be taken if the bank is satisfied that the borrower, although experiencing difficulties, will ultimately be able to repay fully the outstanding balance. However, when a borrower defaults, common sense implies that a loss is likely if security coverage valued on a current market value basis is inadequate, unless a workout can be established which will, in the end, result in ultimate collectability. It is worth stressing that the overall number and significance of workout loans in the portfolio has important implications for the auditor in the "stepping back" process he must perform. This point assumes some prominence in the evidence taken by this Inquiry.

Finally, the appropriations for contingency account is normally stated for unforeseen loan losses. It should not be viewed as a substitute for specific loan provisions.

e. One Hundred Per Cent Financing

The Commission heard much evidence about one hundred per cent financing, which typically, and sometimes unavoidably, occurred in a workout situation. If the borrower has substantial net worth, or other sources of repayment are identified, there is nothing pathological about unsecured or partially secured loans. Where the borrower has no substantial net worth or equity in the project, however, there is a warning to the auditors that a provision may be required because a lack of value in the security is indicated. Where there are many instances of such financing on the bank's books, the auditors must be on guard, and should test the overall adequacy of loan loss provisions. We shall return shortly to the auditing implications of one hundred per cent financing.

f. Fee Income

The appropriate banking treatment for fee income was not discussed in the evidence. Broadhurst testified that fees could properly be capitalized on the same basis as interest. The Commission heard that it was a practice of CCB, but not Northland, to charge a fee for restructuring a loan. At least one large Canadian bank charges fees on restructurings, but this fee income is "very small". Such fees, in another bank, appear to relate to legal or accounting expenses only. The Commission was told that all banks charge commitment fees of between one-half and one per cent of the loan authorization. Northland Bank often charged much larger fees, termed "merchant banking fees", of up to 15 per cent of the loan authorization. Witnesses testified that they had never seen such fees before their examination of Northland's affairs, but these were middle management personnel, not familiar with merchant banking practices. The Inspector General acknowledged that merchant banking goes beyond simply lending money, and involves the provision of services contributing something more to the process of a business deal than merely putting up money for which a bank is entitled to a fee, and that he knew that merchant banking so defined was not an unusal practice in relation to the commercial lending activity. He did say, however, that it is "less than clear exactly what merchant banking is about".

Fees connected with lending or other long term activities taken in lieu of interest are usually amortized, whereas "merchant banking" fees are usually included in income in the year in which the related services are rendered. Northland Bank acknowledged the distinction in a note to its 1984 financial statements:

> The bank generates fees from lending management arrangements and other business advisory services rendered to its customers. Fees connected with

> lending or other long term activities are amortized. Other fees are included in income in the year in which the related services are rendered.

The ambiguity of the distinction between a "fee connected with lending" and "other fees" is illustrated by Fortier's description of how fees were recognized in income:

> ... primarily ... if the deal could not happen — if we facilitated the happening of a transaction through our in-house people, the expertise that they had and they brought to the table and that they brought to the negotiations either with the borrower or with some third party that the borrower was negotiating with, then ... that fee was earned and we almost created the environment for the fee to happen.
>
> Otherwise, if that was not the case, then the fee would have to be amortized. ...

MacKenzie developed the following criteria to be applied in determining whether a fee was charged in lieu of interest, and therefore the appropriate method of taking it into income:

1. The merchant banking activity giving rise to the fee must be, in fact, a "value-added type of service".

2. The scope of the work and the approximate amount of the fees were agreed to by the client in advance.

3. There should be no collateral agreement with the client allowing a rebate of the fee or a subsequent adjustment of interest rates and so forth in order to rebate the fee.

4. That all the work and all the costs related to earning the fees had been incurred.

5. That each property to which the fee related were new properties of the bank, and that this was not merely a "refreshing" of old loans.

6. Finally, that the resulting loans were themselves fully performing on a cash basis with an appropriate interest rate (market rate applicable to that particular class of credit).

The basic test, Mackenzie opined, is whether the resulting loan is of such quality that it can be sold without discount to other financial institutions.

B. AUDIT OF CREDIT DECISIONS

No issue has been raised as to the auditors' physical examinations and procedures. Rather, the crucial issue is whether the auditors adequately responded to the information available to them. Nevertheless, auditors' procedures can usefully be reviewed.

Commercial loans are selected for review with reference to their size and classification. All loans over a certain amount are reviewed, as are loans over some smaller amount that are classified as unsatisfactory, noncurrent, or nonperforming. A test examination is made of the balance of the loans. In each case, the normal procedure is to acquire copies of the board sheets. In some cases, this will be the extent of the review. In others, a cursory review of the files will be made as well. In a third group, the files will be reviewed in detail, and will be discussed with the appropriate officers of the bank. Information is also collected regarding the concentration of the loan portfolio by region and industrial or commercial sector, the percentage of nonperforming loans, the number of restructured or workout loans and their overall significance, concentration of loans to connected borrowers, and any other trends noted in the financial statements or during the examination, including whether the bank has been less conservative in some of its "other income" measurements.

In conducting the audit, the auditor must identify the basis on which management and the internal auditors determined the borrower's ability to pay. The auditor expects to see in the file a rationale for the decision whether or not to take a provision. Broadhurst stated:

> You would have available to you why the credit management in the bank sees fit to make a provision and some indication as to how they arrived at the amount or, on the other side, why they feel, even though they are not looking at the security for one reason or other, there is some question about the ability, why they feel that the security would be adequate, and they would not need to make a provision at that time.

Disagreement on a matter of judgment as to provisioning on a loan-by-loan basis is normal and acceptable. However, the auditor must also "step back" and view the overall loan provision in light of the information collected, trends noted and judgments made. Broadhurst said:

> Insofar as provisioning of loans, I believe there are two essential approaches. One is the examination of certain individual loans, and the second is a stepping back and viewing the overall loan provision in the light of trends noted and judgments made in the examination of individual loans. For example, the more workouts that an auditor finds, the closer would be his examination of workouts. The larger the percentage of nonperforming loans, the more detailed would be his examination of such loans.

MacKenzie made a similar point. He stated that it is important to get an overall impression or "reasonable estimate" of the level of loans where the borrower is not paying interest in cash:

> ... that's where the focus ought to be, because if the bank cannot generate that kind of earnings, that will be a reflection of a host of other problems, nonperforming loans; it could be a reflection of the fact that they have a concentration of assets in real estate, oil and gas or shipping or whatever, but it is, to me, the key indicator and the key thing to look for.

Broadhurst testified that if all the disagreements or assumptions were one way (to increase income and avoid provisions), that would cause him concern.

The auditor must be prepared, based on his own judgment, and in the context of his overall view of the loan provisioning, to disagree with management's judgment and consider qualifying the bank's accounts if the increases in specific provisions that he feels are necessary are not made. Qualification would only be required, however, if the provisions would be material. The auditor must determine whether, in light of the "soft" nature of the figures, the amount of additional provisions recommended is significant in the circumstances. Two subjective judgments are therefore involved: whether a loan provision is required, and whether, when all recommended loan provisions are aggregated, they are material.

The valuation of security underlying a loan is a highly subjective judgmental process. The auditor should look for evidence that the valuation assumes a reasonable time frame for disposition, and is based on assumptions that are reasonable, perhaps tending a little to the conservative side. Appraisals are an important element in the valuation of security, but they are not the final word or the only element. It is not standard practice for an auditor to obtain an independent appraisal.

The fundamental difficulty in loan valuation from the auditor's point of view was well expressed by Mr. Peter Smith of Coopers & Lybrand in England. He testified:

> I think we would have to say there will be circumstances where two banks, each with the same exposure to exactly the same customer on precisely the same terms and conditions ... would arrive at different views as to the recoverability of that particular loan, and both answers may be right, but one bank may decide to provide half the balance and another bank believes it is fully recoverable, but management of the bank has to analyze its exposure and honestly come to judgment based on the facts such as they are. The auditor is then in a position of having to assess whether the bank has acted diligently and come to a judgment in accordance with the facts and may well be able to accept because they are the management's accounts and not the auditor's accounts which could have two different answers in two different banks to what appears to be essentially the same problem.

C. CONCLUSIONS REGARDING BANK AUDITING PRACTICES

It is essential to recognize that the interests of the shareholders and depositors require conservative practices and accounting disclosure of the results of these practices.

In the circumstances disclosed by the evidence, the whole matter can be reduced to two issues: the valuation of security, and the propriety of practices consequent upon such valuation. CCB and Northland management emphasized and utilized the judgment required to determine ultimate collectability of particular loans based on the "three C's" of good credit practices; character, credit, and collateral. The "banker's judgment" was resorted to in the hearings to challenge critical reviews of the two banks' loan portfolios. It was said by witnesses in these banks that only management are familiar with two of these factors; character and credit. There is an element of truth to this. However, again as a matter of common sense, the loans principally occupying the attention of the Commission were workout loans, in which default had already occurred or was anticipated, and a loss would result if no workout was undertaken. No borrower was shown in evidence as willing or able to redeem his security. Many workouts were actually or effectively on a nonrecourse basis. The taking of loss provisions was avoided or at least postponed. Both banks accrued or capitalized interest, and often justified this practice by referring to the worth of the underlying security, adjusted upwards from present value by the addition of some "future value".

Security valuation proceeded in both banks by way of detailed plans to work out a loan or asset and/or on the basis of expected recovery in the economy. It is clear that security valuations based on assumptions about economic recovery are improper; the expert bankers said so and expert audit evidence confirmed it. Common sense favours the same conclusion.

Security valuations based on workout plans in place are also dangerous. It is obvious that not every workout will, in fact, be successful. The auditors must, in light of the number of workouts, assess the overall reasonableness of the picture presented by the financial statements.

Capitalization and accrual of interest and the taking of provisions hinge on the valuation of security. Given the security valuation methods employed, these practices in certain cases were clearly improper. Capitalization and accrual should not occur if there is any doubt about collectability. Doubt exists where collectability depends on unrealistic expectations that plans in place for the workout will be entirely successful. Further, as one approaches 100 per cent financing, Mackenzie's test requiring "more than adequate security coverage" is not met. In many cases coverage was not based on present market values and in some cases, even the least conservative tests for capitalization were not met.

The auditors testified that provisions were made for "likely" losses. However, provisions were rarely made on loan workouts. There are even instances in both banks where no provisions were taken because refinancing was "in progress", even though the arrangements were not yet finalized. In effect, the auditors were content to assume that workouts would succeed until there was evidence to the contrary. In the view of the Commission, this assumption cannot be justified. In a workout situation, where the loan is not well secured on a current market value basis, it is reasonable to presume a loss will occur because the borrower has in most cases already defaulted. A provision should therefore be established at that time, and only as the workout progresses from infancy and its success becomes apparent should the provision be removed. Because it is unreasonable to expect success in every case, the auditors must step back and view the reasonableness of the picture presented by the financial statements on a global basis, considering the frequency of 100 per cent financing and of workouts.

The same comments apply to accrual of interest. In addition, the periods of time over which interest was accrued were improper. It is not acceptable banking practice to accrue interest based on a management override for very long periods of time and in the face of such intervening events as the borrower's receivership.

D. ACCOUNTING CONSIDERATIONS REGARDING REPORTING

In the course of considering recommendations, the Commission has reviewed current reporting requirements and proposed additional ones. These issues are intimately related to the foregoing discussion of expert evidence, and accordingly are dealt with here.

1. Valuation

Valuation of the loan portfolio seems to include the valuation of the loan itself, the borrower's covenant, and the security underlying it as a totality. Once the covenant is dishonoured and thus has no value, valuation of the pledged security, most frequently real estate, is the only process at work. During the course of this Inquiry, the Minister of State (Finance) introduced Bill C-103 in the House of Commons, which proposed as an amendment to the *Bank Act* that the Inspector General have the authority to establish the value of a loan asset in a bank. However, none of the parties appearing before the Commission have sought, and some of them have opposed, such power in the regulator. The Bill, introduced after the major portion of the Commission hearings had been concluded, was not the subject of much direct evidence.

The proposed legislation does not reveal whether this section is in response to any condition laid bare by executive examination of bank regulation. The section is not accompanied by an explanation but simply by the word "new". It appears to be simply the extension to the *Bank Act* of an analogous power conferred on the Superintendent of Insurance with reference to real estate mortgage lending by licensed lenders in that field. In that case, however, the loan is granted in consideration of a conveyance of title, in some provinces called a mortgage, and it is understandable that the value of the mortgage is predominantly the value of the loan. Such is not generally the situation in banking, according to the evidence tendered at this Inquiry. The proposed provision is contained in s.175(3.1):

> Where an appraisal of any asset held by a bank or any of its subsidiaries has been made by the Inspector and the value determined by the Inspector to be the appropriate value of the asset having regard to the appraised value varies materially from the value placed by the bank or subsidiary on the asset, the Inspector shall send to the bank, the auditors of the bank and the audit committee of the bank a written notice of the appropriate value of the asset as determined by the Inspector.

The power of reappraisal granted to the regulator of banks under the proposed s.175(3.1) is much greater than the power granted in the Bill to the Superintendent of Insurance. In the latter case, reappraisals are limited to real estate assets, and the Superintendent is limited to the adoption of a qualified appraisal and cannot simply substitute his own judgment for that of an appraisal relied upon by the financial institution. The CBA urges that the Inspector General's powers be likewise limited. The second, more important position taken by the CBA, is that the regulator's reappraisal power should not be worded so as to enable a global reassessment of the value of all the assets of the bank, but rather should be limited to the valuation of real estate. This observation is based upon the acknowledged degree of judgment and discretion involved in loan valuation. The process is subjective in part, does not lend itself to third party verification, and is a product of the bank credit officer's experience with and understanding of the relationship between the lender and borrower.

It should be noted in passing that the section is ambiguous. The expression "an appraisal of any asset" is the opening description of the situation addressed by the section. Later in the proposed provision much is made of "the appraised value" and the variation between that quantity and "the value placed by the bank ... on the asset". In many fields of the law the word "appraisal" is associated principally with real estate. In general modern-day language usage the word "appraisal" and the verb "to appraise" no doubt can extend to things animate and inanimate, real and personal, corporeal and incorporeal. However, in law it is an unusual application of the verb "to appraise" to apply it to a promise or a covenant of a borrower. The section, though ambiguous, must be taken to include the valuation of all assets including loans secured and unsecured. The CBA would at least limit the proposed power to the valuation of real estate.

The section suffers from further want of clarity in providing that where the Inspector's valuation differs materially from that placed on the asset by the bank, "... the Inspector shall send to the bank, the auditors of the bank and the audit committee of the bank a written notice of the appropriate value of the asset as determined by the Inspector." No mention is made as to whether the Inspector's written notice is a directive comparable to that issued by the Minister under s.175(1) which, under the existing s.175(4), need not be revealed publicly. Nor is it clear whether the written notice under the proposed s.175(3.1) could be considered a directive concerning "unsound business practices" which the Inspector may issue under s.313.1 of the *Bank Act*, also proposed in Bill C-103. If it is, then a right of appeal to the Minister, and subsequently to the Court, is available to the bank. If the written notice in the proposed s.175(3.1) is not included in the new process to be authorized by s.313.1, there is no right of appeal. Of course, the new value would be without purpose even if not carried into financial statements and thence into prospectuses.

The section is a drastic intervention, even assuming the difficulty in solving the problem of valuation. It may be confiscatory, but is unaccompanied by the safeguards which have historically evolved to protect the individual in fields such as zoning and land use law, where legislative action may reduce property values, sometimes without compensation. In banking, if there is a demonstrated need for this power, it is clearly encompassed in the recommendation, made elsewhere in this Report, to include in arsenal of weapons of the regulator the power to issue a cease and refrain order. In the United States, the FDIC has the power to issue "cease and desist orders" dealing expressly with the valuation of loan assets. The basis or standard in law for such an order under the *Bank Act* would be the general power and duty of the regulator to ensure that the business of a bank is conducted prudently, with regard to the interests of shareholders and creditors, and in the public interest. Cease and refrain orders concerning asset valuation should only issue as part of a balanced regulatory scheme in which all interests are subject to scrutiny at the administrative and judicial levels. It should not be forgotten that we are here dealing with the vital issue of the integrity of the citizen's property.

The breadth of the amendments as currently worded approaches a grant of regulatory power akin to that possessed by U.S. on-site inspectors. Adoption of such an inspection system is rejected by the Commission elsewhere in this report. It may be incongruous to provide the wide powers of loan revaluation inherent in the proposed s.175(3.1) without at the same time establishing a "hands-on" bank inspection system. A regulator undertaking the revaluation of a loan assets must be familiar with the credit practices of the bank and the creditworthiness of the borrower in order to make an informed regulatory revaluation decision. The regulator's impact on the valuation process should be focused on supervision of lending and loan valuation practices, as communicated to it, and to the audit committee, by the bank's auditors. Management decisions, properly supervised, are preferable to regulatory fiat in the accepted Canadian tripartite system of bank regulation.

If there is a present compelling need for the extraordinary and startling power given by Bill C-103, it should first be demonstrated. The cease and refrain power should be given a trial run to see whether conventional administrative law processes are not sufficient to protect the interests of bank and community alike.

It is, in sum, the considered view of this Commission that the proposed administrative power to revalue a bank's assets is an extraordinary power in our legal and political system, and cannot without much more than has been seen in the evidence here be recommended. The grant of power, recommended elsewhere, to issue cease and refrain orders where the conduct of the bank is, in the opinion of the regulator, imprudent, is in the Commission's view sufficient.

2. Loan Characteristics for Regulatory Reporting

Regulatory reporting of problem loans is currently controlled by the OIGB Non Performing Loan Paper. The Commission's recommendations emphasize the cash flow reality of problem loans, and aim, in part, at remedying deficiencies in the Paper. To understand these recommendations in Chapter 6, the following background is presented.

"Substandard loans", a term adopted by the OIGB as an interim measure in the OIGB's 1983 pre-inspection questionnaire, was defined as the total of overdue loans (loans where interest had not been paid *by the borrower* for a period of 90 days or more, and other loans treated by the bank as being on a nonaccrual basis) plus "underperforming loans" (loans where the terms of the loan agreement had been renegotiated to provide for a reduction of interest payments due to the weakened financial condition of the borrower). The definition included situations where a bank continued to recognize income by capitalizing interest or accruing it as a receivable. As such, it may be similar to the recommendation made by the House of Commons Standing Committee on Finance, Trade and Economic Affairs in its 1982 study on bank profitability:

> The noncurrent loan category, as defined in the *Bank Act*, should be redefined so as to classify outstanding bank loans according to their contribution to bank income. All loans on which (1) future interest payments are not expected to be received or (2) interest payments have not been received for 90 days or (3) on which bank officials treat interest payments on a nonaccrual basis should be classified as noncontributing loans. All loans on which (1) contractual interest payments have not been made in full and on which (2) the differential is treated on a nonaccrual basis should be classified as partially contributing loans. All other loans should be classified as fully contributing loans. Such information should be included in each bank's annual report.

The OIGB's Non Performing Loan Paper was finalized in June 1984, and mandatory reporting under the new format commenced in 1985 fiscal year. The new reporting requirements are quite comprehensive. It should be noted that the discussion that follows focuses on loans to domestic borrowers, and thus is misleading to the extent that it ignores sovereign loans and claims other than loans. The paper defines various classes of loans as follows:

1. *Non accrual loans*. (NALs) Loans on which interest is not being accrued because of the existence of a reasonable doubt as to ultimate collectability of principal or interest (even if payments are not contractually past due). Loans where interest is contractually past due 90 days are automatically included in this category unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal or interest (the "management override").

2. *Renegotiated Reduced Rate Loans*. (RRRLs) Loans whose terms have been modified to provide for a reduction in the interest rate due to the weakened financial condition of the borrower. NALs and RRRLs are "Non Performing Loans".

3. *Other past due loans*. Loans on which interest is contractually 90 days past due, that have not been included in the NAL category because interest is being accrued pursuant to the management override. As a general rule, where interest is contractually in arrears 180 days, loans

must be classified NAL and removed from this category. Only in "extenuating circumstances" will any loan be permitted to remain in other past due status more than 180 days.

4. *Special surveillance — restructured loans.* Loans other than RRRLs where, due to the weakened financial condition of the borrower, the terms of the loan have been modified. These modifications were stated by the OIGB to include a reduction of principal or the amount payable at maturity, or accrued interest (including forgiveness), or by deferring or extending payments of interest and/or principal. The OIGB expresses the view that this definition will "usually apply for large private sector and sovereign risk loans, where more than one bank is at risk." A senior Canadian bank auditor testified before the Inquiry that "I am not even sure I know what that means".
5. *Special surveillance — loans with general provisions.* This category refers to sovereign loans.

The paper also prescribes income treatment for the various classes of loans. More relevant to the present purpose, the OIGB implemented regulatory reporting on a quarterly basis of these various classes of loans. The following items, among others, must be reported:

1. *NPL Data in the Aggregate.* This includes the total of NALs and RRLs, reported both on a gross basis and net of provisions. Specific provisions must also be reported.
2. *Other Past Due Loans.* These loans, defined above, must be reported in two categories (90-179 days and 180 or more days past due) showing the same information as for NPLs. For this classification, however, interest carried in "other assets" (accrued interest) must be reported.
3. *Trends in Special Surveillance Loans.* The totals of restructured loans and loans carrying general provisions newly classified in the quarter must be reported.

Some of these loans, in particular RRRLs, other past due loans, and special surveillance loans, need not be reported unless they exceed the greater of $500,000 and 1/10 per cent of the paid-in capital, contributed surplus and retained earnings of the bank.

Information other than the amounts of each class of loan is also reported, including:

1. Interest recorded as income on nonperforming loans and other past due loans. In the case of other past due loans, interest is reported for loans past due 90 to 179 days, and separately for loans past due 180 days or more. The current quarter reversal of interest accrued in prior periods on nonaccrual loans must also be reported.
2. Gross nonperforming and other past due claims and special surveillance loans of nonresidents by country.
3. Some newly classified restructured loans, and restructured loans reclassified to NAL must be reported by customer name (with gross balance and specific loan provisions).

In the Commission's view, significant gaps exist in the reporting system, due in part to the definitions in the Non Performing Loan Paper. This matter is pursued in the Recommendations in Chapter 6.

It is pointed out that regulatory reporting must recognize the deficiencies inherent in conventional presentation of financial statements. Difficulties in loan valuation should now be apparent to the reader. This is not, of course, a new issue. A publication entitled The *Elusive Art of Accounting*, offers the following succinct quotation from *The Economist* and comment thereon:

> Anyone who knows anything at all about accounts knows that at almost every turn — the value of stock, equipment and buildings; the method of accounting for research, development and publicity expenditure; the apportioning of tax — the book entries depend on judgments which may possess a large element of guesswork and certainly could have been, equally legitimately, expressed by a different method with totally different figures at the end.

This same publication concludes:

> In short, the only acceptable basis for net income determination is the "better off" view. It is not useful to anyone to claim that a company has earned a net profit of $1,000,000 unless it can be demonstrated that its value has increased by that amount.

This matter is considered further in the Recommendations.

Appendix G

Miscellaneous Data Concerning Conduct of the Inquiry

A. ORDER IN COUNCIL

The Committee of the Privy Council, on the recommendation of the Prime Minister, advise that a Commission do issue under Part I of the Inquiries Act appointing the Honourable Willard Z. Estey to be Commissioner to inquire into and report on the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank including

(a) an examination of all the circumstances and factors contributing to the condition of the banks and resulting in the cessation of their operations; and

(b) regulatory action in dealing with these conditions and circumstances taken by the Government of Canada and its agencies, including the Bank of Canada; and

if the Commissioner concludes that the circumstances so require, to recommend any changes in the regulatory and administrative control of the banking industry in Canada that the experience of the matters reviewed in the course of the inquiry may show to be necessary or advisable.

The Committee further advise that

(a) the Commissioner be authorized to

   (i) adopt such procedures and methods including the holding of hearings whether in public or in camera as he may consider expedient or necessary, for the proper conduct of the inquiry and to sit at such times and at such places within or outside of Canada as he may decide;

   (ii) engage the services of such staff and counsel as he may consider necessary or advisable, at such rates of remuneration and reimbursement as may be approved by the Treasury Board;

(iii) engage the services of such experts and other persons as are referred to in section 11 of the Inquiries Act who shall receive such remuneration and reimbursement as may be approved by the Treasury Board;

(iv) rent office space and facilities for the Commission's purposes in accordance with Treasury Board policy; and

(v) submit from time to time to the Governor in Council, such interim reports as he may consider advisable; and

(vi) perform such other functions as may be necessary to carry out his duties;

(b) the Commissioner be directed to submit a report in both official languages to the Governor in Council embodying his findings, and recommendations as soon as possible and to file with the Clerk of the Privy Council his papers and records as soon as reasonably may be after the conclusion of the inquiry; and

(c) pursuant to section 37 of the Judges Act, the Honourable Willard Z. Estey be authorized to act as Commissioner in the inquiry.

B. WITNESSES AND INDIVIDUALS WHO APPEARED BEFORE THE INQUIRY

Karl Adamsons	—Inspector, OIGB
J. Wallace Beaton	—Real Estate Management and Consultant
Michel Bélanger	—Chairman and CEO, National Bank of Canada
Gerald Bouey	—Governor, Bank of Canada
André Brossard	—Director, Compliance Division, OIGB
Edward Ernst Brauer	—President and CEO, Universal Industries, Lloydminster

William H. Broadhurst	—Chairman and Senior Partner, Price Waterhouse, Toronto
Harvey Brooks	—Vice-President, Western Division, National Bank of Canada
G. Douglas Carr	—Partner-in-Charge, Audit Practice, Peat, Marwick, Mitchell & Co., Toronto Office
John Carchrae	—Assistant Director, Accounting Standards, CICA
Bruce Cockburn	—Vice-President, World Corporate Banking, Royal Bank of Canada
Marshall A. (Mickey) Cohen	—Former Deputy Minister of Finance Government of Canada
Stanley Cook	—Contract Inspector, OIGB (retired, formerly CIBC)
Joseph W. Courtright	—Inspector, OIGB
Jean-Pierre Cristel	—Quebec Securities Commission
W.K. (Bill) Detlefsen	—Partner, Thorne Riddell, Calgary
John T. DesBrisay	—Director, CCB
Alan J. Dilworth	—Senior Partner, Touche Ross and Company
John Easton	—Vice-President, Credit Audit and Corporate Audit, Royal Bank of Canada
Ira Milton Farthing	—Bank of Nova Scotia, retired
Rowland Frazee	—Chairman, Royal Bank of Canada
M. Fortier	—Chief Operating Officer, Northland Bank

R. Donald Fullerton	—Chairman, President and CEO, Canadian Imperial Bank of Commerce
J. Maurice Gaudet	—Senior Vice-President, Special Credits, CCB
Robert Gemmell	—Assistant Vice-President, Wood Gundy, Calgary
Prof. Charles Albert Eric Goodhart	—Chief Economic Advisor, Bank of England
Robert Grandy	—Vice-President and Director, Wood Gundy, Calgary
Neville Grant	—Director, Inspection Division, OIGB
Charles F. Green	—General Manager & Director, Financial Control Division, National Westminster Bank, London
R. Guenette	—Vice-President, Credit, Northland Bank
A. Guetta	—Mathematician
Paul Guy	—President, Quebec Securities Commission
Dr. Hu Harries	—Economic Consultant
James A. Hillman	—Director, CCB
George C. Hitchman	—Deputy Chairman of the Board, Bank of Nova Scotia, retired
Richard Humphreys	—Superintendent of Insurance, retired
Mel Hurtig	—Publisher, Edmonton
W. J. Inwood	—General Counsel and Secretary, Royal Trustco Limited

J.R. Johnston	—Commercial Branch Manager, Toronto-Dominion Bank, Edmonton
Lucille M. Johnstone	—Director, Northland Bank
William A. Kennett	—Inspector General of Banks, OIGB
Gordon W. King	—Director, Capital Markets Division, Department of Finance
R. W. Korthals	—President, Toronto-Dominion Bank
William Krehm	—Author and Economist
R.G.D. Lafferty	—Lafferty, Harwood and Partners, Montreal
A.C. Lamb	—Comptroller and Chief Accountant, Bank of Canada
R.W. Lawson	—former Senior Deputy Governor, Bank of Canada
H. Graham LeBourveau	—Partner, Clarkson Gordon, Calgary
Robert E. Lord	—Managing Partner, Clarkson Gordon, Edmonton
Garth MacGirr	—National Insolvency Partner, Price Waterhouse Limited; Liquidator of CCB
Robert M. MacIntosh	—President, Canadian Bankers' Association
Michael A. MacKenzie	—Partner, Clarkson Gordon, Toronto
Donald M. Macpherson	—Assistant Inspector General of Banks, OIGB
Barbara McDougall	—Minister of State for Finance, Government of Canada
Roderick J. McKay	—Partner, Thorne Riddell, Calgary
Iain McLeod	—Chief Inspector, Northland Bank

Gerald McLaughlan	—President and CEO, CCB
Paul Melnuk	—Vice-President, Controller, CCB
Bill Mitchell	—Partner, Price Waterhouse, Toronto
James A. Morrison	—Senior Partner, Touche Ross and Company, Toronto; Liquidator of Northland Bank
William D. Mulholland	—Chairman and CEO, Bank of Montreal
Steve Mullie	—Assistant Vice-President, Wood Gundy, Calgary
William Neapole	—President and CEO, Northland Bank
A. Opstad	—Consulting Electrical Engineer
Paul B. Paine	—Chairman, CCB
Walter A. Prisco	—President and CEO, Northland Bank (1981-1982)
Cedric Ritchie	—Chairman and CEO, Bank of Nova Scotia
Prof. Brian L. Scarfe	—Professor of Economics, University of Alberta
Prof. Hal Stewart Scott	—Professor of Law, Harvard University
Edward J. Shaske	—Accredited Appraiser, Appraisal Institute of Canada
Guy Shedleur	—Quebec Securities Commission
John M. Sherman	—Independent Businessman and Consultant
Robert V. Shumway	—Director, Division of Bank Supervision, FDIC

D. Skagen	—Director, Northland Bank; Vice-Chairman of the Board, Northland Bank
J. Crawford Smith	—Partner, Clarkson Gordon, Calgary
David E. Smith	—Executive Vice-President, Canadian Credit, CCB
P.A. Smith	—Partner, Coopers and Lybrand, London
Robert Steen	—Deputy Director, Corporate Finance, Ontario Securities Commission
Gordon Tallman	—Vice-President, Commercial Banking and National Accounts for Alberta, Royal Bank of Canada
Allan Taylor	—President and COO (now CEO and Chairman), Royal Bank of Canada
Robert James Taylor	—Royal Bank of Canada, retired
Serge Vachon	—Chairman, Canadian Payments Association, Adviser to Governor of Bank of Canada
R.A. Willson	—Chairman, Northland Bank
Stan Willy	—Chief Inspector, Northland Bank (1983)
Michael Wilson	—Minister of Finance, Government of Canada

C. INDIVIDUALS WHO MADE SUBMISSIONS BUT DID NOT APPEAR BEFORE THE INQUIRY

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The Commission received a considerable volume of other correspondence which made no formal submissions.

D. COUNSEL APPEARING AT THE INQUIRY

Government of Canada	Edgar Sexton, Q.C., Toronto M.L. Phelan, Ottawa L.P. Lowenstein, Toronto Ian Binnie, Q.C., Ottawa Graham R. Garton, Ottawa Peter J. Dey Q.C., Toronto
Bank of Canada	Gordon F. Henderson, Q.C., Ottawa Robert M. Nelson, Ottawa George N. Addy, Ottawa
Office of the Inspector General of Banks	Claude R. Thomson, Q.C., Toronto Donald E. Short, Toronto T.B.O.E. McKeag, Q.C., Toronto R. Staley, Toronto
Canada Deposit Insurance Corporation	Charles F. Scott, Toronto
Clarkson Gordon and Thorne Riddell, Auditors of Northland Bank	J.C. Major, Q.C., Calgary
Clarkson Gordon and Peat Marwick, Mitchell Auditors of CCB	J.E. Redmond, Q.C., Edmonton J.W. Beames, Q.C., Edmonton
Certain CCB Directors	Pierre Genest, Q.C., Toronto W.E. Pepall, Toronto K.K. Bell, Toronto
Certain CCB Management	A.T. Murray, Q.C., Edmonton M.J. Trussler, Edmonton D.C. Rolf, Edmonton
The Bank of Nova Scotia and the Canadian Imperial Bank of Commerce	A.J. MacIntosh, Q.C., Toronto W.J. Mandzia
The Royal Bank of Canada	L.Y. Fortier, Q.C., Montreal C.A. Carron, Montreal Joseph A. Day, Ottawa

Northland Bank Directors	J.R. Smith, Q.C., Calgary
Northland Bank Management	T.F. McMahon, Q.C., Calgary S.F. Blyth, Calgary
Her Majesty's Loyal Opposition	A. Lutfy, Ottawa
Price, Waterhouse Limited	E.A. Goodman, Q.C., Toronto J. Ryan, Toronto A. Jacques, Toronto T. Saskin, Toronto B.W. Ashley R. Howard
Mr. H. Brooks	M.A. Putnam, Q.C., Calgary
Bank of Montreal	C.L. Campbell, Q.C., Toronto M. Freiman
Canadian Bankers' Association	J. Frances D. Phillips
Mr. James A. Morrison (Liquidator of Northland Bank), Mr. John Easton, and Mr. Iain McLeod	P.B.C. Pepper, Q.C., Toronto B. Chambers, Q.C.

E. INQUIRY STAFF

Counsel

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Peter Howard
Nigel Campbell
D. McDermott, Q.C.
R. Wildeboer

Executive Secretary

Paul Ollivier, Q.C.

Legal Staff

Jamie Benidickson
David Cohen
James T. Eamon
Katherine J. Young

Bank Auditing Advisor

Vernon Turley

Accounting and Economic Advisors

Gordon A. Brown
Jacques Singer

Assistant Secretary

Donna Stebbing

Supervision of Translation

François Patenaude

F. INQUIRY SCHEDULE

Hearings: Commenced:	WEDNESDAY, OCTOBER 2, 1985
Closed:	THURSDAY, MAY 22, 1986
Total No. of Days of Hearings:	75
Hearing Dates:	Week 1: OCTOBER 2, 1985 (Preliminary Hearing)
	Week 2: OCTOBER 7-9, 1985
	Week 3: OCTOBER 21-24, 1985
	Week 4: OCTOBER 28-31, NOVEMBER 1, 1985
	Week 5: NOVEMBER 4 & 8, 1985
	Week 6: NOVEMBER 18-22, 1985
	Week 7: NOVEMBER 25-30, 1985
	Week 8: DECEMBER 5 & 6, 1985
	Week 9: DECEMBER 9-13, 1985
	Week 10: JANUARY 20-24, 1986

Week 11: JANUARY 27-31, 1986

Week 12: FEBRUARY 3, 6 & 7, 1986

Week 13: FEBRUARY 26 & 27, 1986

Week 14: MARCH 3-7, 1986

Week 15: MARCH 10-14, 1986

Week 16: MARCH 17-21, 1986

Week 17: MARCH 24-27, 1986

Week 18: MAY 12-16, 1986

Week 19: MAY 20-22, 1986

Hearings Held at:

Commission of Inquiry on the Collapse of the CCB and Northland Bank
20th Floor West Tower
L'Esplanade Laurier
300 Laurier Avenue West
Ottawa, Ontario

Supreme Court Building
East Court Room
Wellington Street
Ottawa, Ontario
(October 2 & 7, 1985)

Convention Centre
9797 Jasper Avenue
Edmonton, Alberta
(November 18-22 & 25 & 26, 1985)

Four Seasons Hotel
10235 101 Street
Edmonton, Alberta
(November 27-29, 1985)

Law Courts Building
Edmonton, Alberta
(November 30, 1985)

Palliser Hotel
133 9th Avenue S.E.
Calgary, Alberta
(Weeks 14, 15, 16, 17 and 19)

Transcripts: 75 VOLUMES
Approx. 13,591 pages — public hearings
65 pages — in camera hearings

Exhibits: Total No. of Exhibits: 249 (plus numerous sub-exhibits)

Witnesses: Total No. of Witnesses and Individuals who made Submissions to the Inquiry: 85